



University of Kentucky  
College of Agriculture,  
Food and Environment  
*Cooperative Extension Service*

Youth Scholar/Junior Leader: \_\_\_\_\_

# American Private Enterprise System



## Program Manual

Council of Cooperatives





Welcome to the American Private Enterprise System—a study of how our economy works at the national and local levels. This program includes the following content information and discussion topics:

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*“I believe in an America where the free enterprise system flourishes for all other systems to see and admire - where no businessman lacks either competition or credit - and where no monopoly, no racketeer, no government bureaucracy can put him out of business that he built up with his own initiative.”*

—President John F. Kennedy



You should enjoy your study of the American Private Enterprise System. After all, you are a vital part of the system. You will have an opportunity to meet and talk with leaders in your community during this project, and there should be productive give-and-take time between you and the speakers. The success of the discussion method used in this program depends on how well you prepare in advance and how well you actively participate in each session.

Your discussion leaders are business and professional leaders of the community who have

volunteered to share their knowledge and viewpoints with you as they lead you in discussing the topics of the program. Remember to personally thank each adult leader who works with you and others in this project. They will appreciate your courtesy. You are one of a number of high school juniors and seniors throughout the state selected to participate in this project at the local level. Top Youth Scholars from each program may participate in the Kentucky Youth Seminar in June at the University of Kentucky. We hope to see you then!



Part I:

# How America Is Organized to Do Business

“Having seen a non-market economy, I suddenly understood much better what I liked about a market economy.”  
—Ester Dyson

## How It All Started

The United States in its 200-plus years of existence has grown to be the economic wonder of the world, bringing forth richness from its farms and factories unprecedented in all history. During this period, we have also enjoyed a unique form of democratic government that has been an inspiration to freedom-seeking peoples around the globe. Because we have a democratic government, our country goes where we (all of us together) decide we want to take it. These decisions can be made wisely only if the choices we make are based on an adequate understanding of our economic system.

## Economic Systems

Economics is everybody’s business. An economic system refers to a process through which labor, resources, and skills are brought together to produce and distribute the enormous variety of things people need and want. These things include goods (food, clothing, cars, factories, etc.) and services (transportation, education, health care, public safety, etc.).

### Three Basic Questions

Since there are limits to what can be produced, basic choices must be made. Economies must answer three central questions:

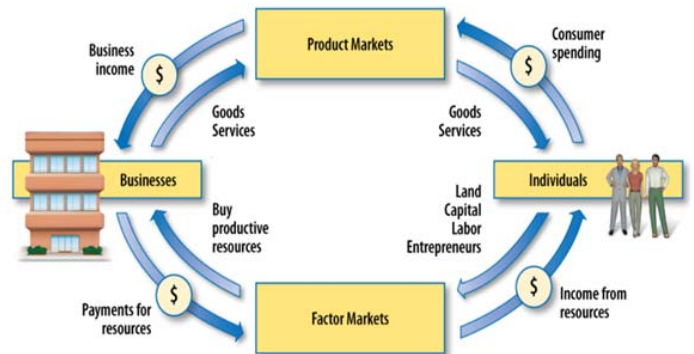
1. What to produce?
2. How to produce it?
3. For whom to produce it?

### Comparing Economic and Political Systems

Different countries have developed different ways of answering these three questions. Knowledge of economic systems in other parts of the world can help us understand our American economic system better. Although economic and political systems in each country are related in important ways, we should be careful not to confuse the economic and political aspects of each political/economic system.

- **Capitalism** refers to a market economy with resources owned primarily by private individuals and groups.

Circular Flow of Economic Activity



- **Socialism** refers to an economy that depends heavily on the government to plan and make economic decisions and to own and control important economic resources.
- **Communism** describes a socialist economy ruled by a single political party that controls the use of all economic resources.

In some nations, including our own, individuals are free to choose their personal goals and to decide how their work and resources will be used. In other nations, only a small group of leaders have this power.

We have what is called a *market economy*. It involves economic decision making by three groups: consumers, producers, and governments. Their decisions are guided primarily by the interplay of buyers and sellers in the marketplace. Market economies can exist in democratic political systems, as in the United States, or somewhat more authoritarian systems, as in Spain.

The same is true of socialist economies. In the case of Sweden, democratic political processes guide a socialist-oriented economy: in the former Soviet Union, a socialist economy was ruled by a single group, the Communist Party. In today’s world, most major industrial nations are market economies, while socialism is common among developing nations.

## Three Forms of Political Economies and How They Work Today

### Capitalism

**Production:** Private individuals own land and businesses, operating them for profit. The market mainly determines what goods are sold at what prices.

**Pay:** Wages are set between employees and management at individual firms, with workers often represented by unions.

**Government:** It regulates business largely by telling firms what not to do. It stimulates output through incentives and usually provides tax-supported social benefits.

### Communism

**Production:** The state owns the sources of production, and these are managed by officials. Central planners set production quotas.

**Pay:** Government sets wages. Free trade unions are prohibited.

**Government:** The Communist Political Party is the only political party, and that party rules all.

### Socialism

**Production:** Elected government gradually takes control of key industries. Authorities often plan output for use rather than profit.

**Pay:** Strong trade unions bargain with management and often serve as the fountainheads of socialism.

**Government:** It allocates resources and uses taxing power to redistribute wealth.

## What Our Economy Provides

We now have some familiarity with the elements of our economy, how decisions are made, and how the system works. Now we can look at the extraordinary dimensions of our American economy—the things it provides.

### How Big Is Our Economy?

One way to measure the size of our national production is to add together the value of all the goods and services we produce in one year. The total is called the **Gross Domestic Product**, or **GDP**. GDP doesn't measure total transactions, only final output. We constantly see and hear references in the news to this total as a yardstick of our production. The GDP does not include do-it-yourself activities, such as housework or home gardening. It also does not measure expenses, such as cleaning up our environment, only market activities.

In 1999, our GDP totaled more than \$9.2 trillion, adjusted for inflation. Its size was greater than those of Russia, Germany, and the United Kingdom combined.

To better understand this over-whelming figure, think of it as about \$32,448 worth of goods and services per American.

### Income

We earn income by being paid for applying our skills, efforts, and resources to some productive purpose. In this activity, we produce goods and services for others—and income for ourselves. This income, in turn, allows us to buy the goods and services we want.

If we add all of the incomes of individuals and businesses earned through producing goods and services during one recent year, the total is more than \$5.46 trillion. As you might expect, most of this income went to employees in wages and benefits.

National income = GDP *plus* receipts or income from abroad, payments abroad, consumption of fixed capital, taxes, and subsidies.

## WORLD TRADE: A POCKETBOOK ISSUE FOR EVERYONE

More than ever before, the United States is becoming dependent on other nations for many of the goods and services American consumers want. Shoes, oil, computers, cars, clothes, and DVDs are just a few of the items foreigners are sending here in huge quantities. As a result, U.S. shoppers, retailers, and travelers are learning that they need to know more about foreign economic conditions and exchange rates that affect their decisions on what to buy or sell abroad. If Japan's yen increases sharply in value, consumers might see higher prices for Japanese cars. If the German mark declines, it can mean cheaper hotel rooms for tourists in Munich.

Purchase decisions are made even harder as it becomes more difficult to determine whether a product is Japanese, European, or American. A television set, for example, might have parts from Japan, a speaker from Singapore, and a picture tube from the United States, with the assembly work done by workers in both Mexico and the United States. One thing is certain: never again will the United States be as self-sufficient as it was in the years immediately after World War II, when it had most of the world's manufacturing plants, much of the advanced technology, and the greatest amount of capital.

### Stronger Economies

The improved health of many countries' economies that languished after World War II is behind the growth in trade. Japan's sales to the

United States generally exceed its purchases. Western Europe sells autos, steel, and other products here in large amounts. Small countries such as Singapore, the Philippines, Taiwan, and South Korea have become major manufacturers of our textiles and home-entertainment devices. Purchases from overseas often mean lower prices and greater variety among items Americans buy as well as the loss of thousands of real or potential American jobs, as imports take away sales that otherwise might have gone to U.S. firms.

Buying from foreigners represents only one side of the trade picture - the import side. To pay for imports, a country tries to export its products to other countries. The United States has found that the emerging health of its trading partners means their consumers can afford more American goods. In 1999, we imported \$1,029 trillion dollars' worth of goods and exported \$684 billion worth. Despite these huge sales, the U.S. deficit on merchandise trade with other nations—imports compared to exports—reached \$345 billion.

The trade deficit isn't the whole story, however. Also to be considered is the money the United States takes in from three other major areas: sales of services, foreign-investment transactions, and profits by multinational corporations. Increasingly, U.S. firms are performing moneymaking services in other countries in the areas of banking, transportation, communications, data processing, and investments. The nation also gets funds from foreigners in the form of vast investments. For example, high interest rates make it attractive for foreigners to deposit their money in U.S. lending institutions, to buy bonds, and to make other investments. Declining interest rates, however, have the opposite effect. Profits by U.S.-based multinational corporations, with branches and factories in many countries, also help offset the trade deficit.

## Exchange Rates

Every year, deals between countries are affected markedly by wide fluctuations in the value of each country's currency—the exchange rate. The exchange rate of the American dollar, for example, is the number of dollars or cents it takes to buy a Japanese yen or other currency. When the dollar is rising against the yen, it takes fewer dollars to purchase the same number of yen. When the dollar is falling, it takes more dollars to buy yen. An increase in the value of the dollar makes imports less expensive in the United States, but U.S. exports cost more abroad. If the dollar loses value, the opposite happens: imports become more expensive here, and U.S. businesses enjoy larger sales abroad.

**Example:** Most cameras are now made in Japan and other Asian countries. If the U.S. dollar

depreciates against the Japanese yen from 120 to 100 yen per dollar, a camera that used to cost \$50 will cost more than \$60. The main reason is that those cameras are sold in yen by the Japanese manufacturer, so it takes more dollars for a U.S. importer to obtain the necessary yen to purchase each camera than before the depreciation. Specifically, at U.S. \$1 = 100 yen, one yen costs exactly 1 cent, but at U.S. \$1 = 120 yen, one yen costs less than a cent or exactly 0.83 cents per yen.

## Enter the Tariff

There are times when the rules break down. When one country loses the advantage, it may decide to protect its own industries by imposing tariffs to raise the prices of imports. Tariffs are taxes a government places on internationally traded goods to protect its prices. Or it may subsidize products for export. Especially during hard economic times, pressures mount on governments to protect workers and businesses that are hurt.

While trade barriers may work in the short run, most trade experts fear that everyone suffers in the long run. For example, tariffs placed on imported automobiles actually increase the cost to American consumers.

## THE NEED FOR CHOICES

All of our needs and desires cannot be fully satisfied, nor will they ever be in a world of limited resources. Throughout history, many societies have attempted to solve this problem by dictating what individual needs and wants should be—and by controlling how these needs and wants are met. Yet economic freedoms and personal freedoms have a way of interlocking. When individuals are told how they must conduct their economic lives and when there are obstacles to such economic freedoms as spending choices and career choices, personal freedoms are inherently involved.

In the American economic system, decision-making is shared by consumers, producers, and governments. Our challenge—and privilege—is to make wise choices in our use of economic resources to satisfy our private and public needs and wants, now and in the future.

## Considering Alternative Benefits

What benefits do we gain when we make a particular economic decision compared with the benefits we might have gained by making another? We must always consider the alternatives. What we are discussing is an economic concept known as *opportunity cost*. When limited resources are used,

some benefits are gained, but some are also sacrificed. So there is a cost involved in our choice.

This concept applies to all economic choices. For instance, in our own lives we make choices such as these:

- Spending for things today or saving for the future
- Balancing spending for food, clothing, and shelter against spending for entertainment and recreation
- Undertaking extra work or spending that time on leisure
- Comparing the potential benefits of higher education with the cost and sacrifices it normally requires

Key public issues also require choices:

- How much government involvement in our economy is necessary for its continued well-

being? In what areas should there be less involvement? In what areas, more?

- How can we balance national growth with conservation of natural resources and protection of our environment?
- How can we evaluate the long-term economic and social costs and benefits of various government programs?
- How can we hold down inflation and yet stimulate the economy and expand employment?
- How can we preserve the benefits of competition in our American economic system and still meet the needs of the less fortunate?

Answers to such questions are anything but simple. Yet these issues directly affect our own future, our children's future, and our nation's future. Under our American economic and political systems, such answers depend on the choices we all make.



## PART I

### QUESTIONS FOR DISCUSSION

1. Is the role of choice equally important in all economic systems?
2. When you become a member of a group such as this one, should you be willing to give up some of your personal freedom and assume some added responsibility? Why? What are some examples?
3. What is an economic system? What does it do?
4. What are the basic CHOICES that must be made with regard to the production of goods and services in any economic system, e.g., in the United States or in Cuba or in mainland China?
5. What kind of economic system do we have in the United States?
6. Most major industrial nations of the world, such as the United States, are largely MARKET ECONOMIES, while socialism is more common among developing nations. Why is this? Is one system better for us, while another system might be better for a less developed country?
7. What three groups have important decision-making roles in our economy in the United States today? In what way?
8. Are you individually a CONSUMER or a PRODUCER, or are you a part of GOVERNMENT, as the terms are used here? Are you all three?
9. How does your answer influence your perspective as to your individual responsibilities in consuming or producing or in influencing the role of government in our economy?

### IDEAS FOR FURTHER STUDY AND TOPICS FOR TALKS OR DEMONSTRATIONS

1. Pick a country and examine how it answers the three basic questions of what to produce, how to produce it, and for whom to produce it.
2. Pick a country and see the importance of the roles of producer, consumer, and government in economic decision-making.
3. Invite a labor leader or government representative to talk to this group about their role in the U.S. economy.



Part II:

# Our Economy – How it works, what it provides

*“You can make positive deposits in your own economy every day by reading and listening to powerful, positive, life-changing content and by associating with encouraging and hope-building people.”*

—Zig Ziglar

## INTRODUCTION

While members of all three groups, consumer, producers, and government, make decisions in our economic system, the key role that really makes everything work is played by you in your role as a consumer.

## CONSUMERS

Today, almost two-thirds of our nation’s total economic output consists of goods and services bought by individuals and households for personal use. The remaining one-third is bought by businesses and governments. So you can clearly see the importance all of us play as consumers in today’s economy.

Every day we make decisions to buy or not to buy, and these decisions directly affect our economy. Our willingness and ability to spend our money for certain goods and services are called the *demand* for these things. Demand is influenced by the prices, quality, and availability of goods and services. If the price of something rises, we often decide to buy less of it or to buy something else. If the price goes down, we might buy more of it.

When our incomes change, our demands are affected. We buy less or shift to cheaper items when our incomes go down. We tend to choose more expensive items or simply buy more when our incomes go up.

Our demand for goods and services affects the efficiency of producers. Most of us look for good values when we buy, and we are increasingly concerned with product safety and reliability. We try to select goods and services that will serve us best and have the highest quality for the price.

This rewards efficient producers that keep quality up and prices down and penalizes inefficient ones. To succeed, producers must continue to offer goods and services consumers want. The *cost squeeze* has set off a flurry of changes in the marketplace. For example, some people now are settling for smaller homes, such as townhouses, condominiums, and the like.

Even though the general consumer trend is to cut costs, the expanding number of working women has created a brisk market for convenience goods. And among working couples with no children, whose combined annual incomes are often \$50,000 or more, the demand for luxury goods and services has remained steady even in a time of recession.

Although every household has slightly different spending priorities, about \$8 of every \$10 on average goes for necessities, such as food, clothes, shelter, and medical care. Health spending alone accounts for \$1.50 of every \$10 in total consumer outlays. What’s left over goes mostly for nonessential goods and services—a new stereo, vacation trips, cosmetics, sporting goods, and movies, to name just a few.

## SUPPLY AND DEMAND

America’s businesses are the suppliers in the basic supply-and-demand equation that is at the heart of the free-enterprise system. In a nutshell, that’s how the U.S. economy works: The matching up of consumer needs and desires with the goods and services offered by businesses at a price considered fair by both parties. When buyers’ desires change, businesses must respond or be swallowed up by the competition. For example, the auto industry found troubles, when it was slow to adjust to the desire for smaller cars.

For businesses, the best of all worlds would be to maximize profits by making or selling goods that are most in demand, because the more consumers want an item or service, the more they are willing to pay for it. Thus, firms have an incentive to sell video games, for example, when consumer demand is high for that product.

Problems crop up for businesses when too many firms enter a field to meet the consumers’ demand for a product or when the price rises beyond the point individuals consider reasonable. In both instances, the result is that too much of a product is produced and prices drop, putting a squeeze on business profit.



## Wooing the Consumer

How do consumers keep abreast of what goods and services are available—and at what cost? Mostly through advertising messages on television and radio, in newspapers and magazines, on billboards, and through the mail. In one recent year, business poured nearly \$118 billion into advertising, according to estimates by *Advertising Age*. In addition to the traditional methods of advertising, technology has begun to play a vital role in advertising. Most, if not all, companies have an Internet site where consumers can research their products and purchase them online. Consumers enjoy the convenience of not having to leave their home to purchase products. Companies are spending billions of advertising dollars to get their products on the Internet to meet the demands of consumers.

## CREDIT AND SAVINGS

In the scramble to lure the consumer, U.S. industry would be at a loss without another important tool: credit. Particularly in the purchase of big-ticket items, such as homes, autos, and major appliances, credit enables consumers to buy without having to put up all the cash at once. If buyers can meet their time payments, credit serves a vital purpose by allowing them to enjoy goods and services now, rather than having to wait. But there's a danger, too. Recently, personal bankruptcies were at an extreme high—the result, experts say, of the inability of many families to manage credit obligations. Altogether, the amount of money owed by American consumers has been \$729 billion.

The economy can suffer from such excesses, too. Retail sales stagnate or fall when consumers become concerned over their debts or the high interest rates they must pay on everything from credit cards to home mortgages. For example, outstanding consumer and mortgage debt as a percentage of after-tax disposable income reached record levels in late 1979, and then declined for two years in a row. From 1980 to 1999, mortgage debt increased from \$1.460 billion to \$5.7 billion.

Most analysts view a drop-off in consumer debt as a good omen. Rather than spend and borrow, say the economists, consumers should put more of their money into savings and investments. That would make more funds available to companies to build and modernize, thus creating more jobs for Americans and allowing U.S. firms to compete more effectively with foreign firms.

During the last several years, the United States, France, and Italy were the only three industrialized countries to register a decline in the rate of personal savings. During the 14-year period 1980 through

1994, personal savings in the United States declined from 7.9 to 4.1 percent of disposable personal income.

## PRODUCERS

Producers are those who work by themselves or in groups to provide goods and services. They make economic decisions based on what they believe the demand will be for their products or services—and they expect to earn an income from what they do.

Who are these producers in the American economic system? You might think only in terms of large businesses, but, in all probability, you are a producer yourself. Workers are producers. They apply their basic skills and energies to change resources into goods and services.

Managers are producers. They produce when they coordinate, plan, and organize the actual production of goods and services. About one-third of all wage and salaried employees are managers, supervisors, or administrators.

Investors are producers. They supply the money, or financial capital, needed to buy and use facilities, equipment, and raw materials.

You may well be helping to supply financial capital without realizing it. If you have a savings account, own shares of stocks, own life insurance, or are in a pension fund, you are helping to generate funds for investment purposes. Banks, savings and loan associations, and the stock markets help put the savings of people to work. By financing home and business investments and creating new loans, they play a vital role in our economic system.

People who start businesses are producers. These people who start new enterprises or businesses are called *entrepreneurs*. Their vision and originality have always played a key part in the growth of our economy by providing new goods, services, and jobs. Some of America's famous inventors have been entrepreneurs.

Although you may not have thought of yourself as a producer, you can probably see at least one way in which you are.

## HOW THE WORKFORCE IS BEING TRANSFORMED

Workers form the backbone of American enterprise. White-collar and blue-collar; skilled and unskilled; merchants, farmers, and professionals—men and women in the work force do far more than earn a livelihood. More than 143 million strong, they are both producers and consumers of goods and services and are sources of both the supply and the demand

that drive the nation's commerce. Yet the nation's labor force is undergoing important changes:

- Automation is eroding job opportunities in old-line manufacturing industries while creating vast new ones in high-technology and service fields.
- Labor unions, after decades of growth, are losing power.
- Women and more mature workers are playing bigger roles.
- Young people, particularly African Americans and Hispanics, are continuing to find it difficult to land competitive jobs.



For most Americans, having a job is a basic requirement for participating in the economic system. Those without jobs find themselves with little control of their own destiny, dependent on others or the government for their welfare.

Wages and salaries earned by working people are the chief source of personal income in the United States, recently amounting to nearly \$6.1 trillion, of all personal income. Virtually all of this income is plowed back into the economy through spending, savings, investments, and taxation.

But workers derive more from their jobs than just a paycheck. Such important items as health insurance, old-age pensions, and paid vacation time are typical of the benefits that go along with many jobs.

Just as workers need jobs to sustain their livelihood, industries cannot function properly without an adequate supply of trained workers. Matching up jobs with qualified workers is a complex process that in a free-market economy depends on the forces of supply and demand. The process is not always a smooth one. Demand for labor frequently changes more rapidly than the supply. For example, it might take a company in Phoenix several months to locate and hire 100 electrical engineers it needs for a business expansion. Finding a shortage of qualified people, the company might have to lure employees away from other companies by offering big salaries and other benefits. Over time, such strong demand in the field might encourage students entering college to major in electrical engineering, assuring that future needs will be met. Too heavy a response could produce a surplus.

Labor surpluses occur on a wide scale during periods of recession, when business activity slows and the need for workers declines. The result is massive layoffs. The resulting economic hardship does not stop with those who are jobless. Entire regions often feel

the impact as retail spending and tax revenues falter. This, in turn, can lead to still more unemployment.

## CHANGING WORKPLACE

About 21 percent of the labor force holds manufacturing jobs. Experts look for little employment growth overall in this field and an outright decline in some industries as unskilled workers are replaced by robots.

Service occupations now account for the largest share of American workers—nearly 116 million people, or 80 percent of the nonagricultural work force. This broad field includes occupations such as nurses and hospital attendants, hotel and restaurant workers, police officers, firefighters, and janitors.

Another important trend in the U.S. labor force is the growing ranks of female workers. The number of women holding jobs has grown—from fewer than 22 million in 1960 to 67.5 million at the most recent counts. While this increase reflects both rising divorce rates and decisions of many women to stay single longer, women now make up 47% of the labor force and 73% work fulltime.

## Government

We have seen that consumers and producers make decisions in the American economic system. Government also gets into the decision-making process. Because consumers obtain benefits from competition, our government has traditionally sought to maintain a competitive environment for business. This intercession often takes the form of laws or regulations intended to prevent abuse in specific areas. Of course, many government regulations also deal with product standards, environmental impacts, and other matters not directly related to competition. We will talk more about the role of government in Part III.

## HOW OUR ECONOMY FITS TOGETHER

Our economy can be thought of as a gigantic machine. So far, we have looked at the different parts and what they do. Now, in order to understand the economy more fully, it will be helpful to look at how the whole machine fits together and works. The concept of supply and demand is central to this understanding.

## Supply, Demand, and Prices

We touched on the subject of supply and demand briefly in Part I. It is something we come in contact with every day.

For example, supply and demand affect the wages we are paid; our wages are actually the prices we

charge for performing work. Supply and demand also affect the prices of goods and services, the prices of raw materials, and the price, or interest, paid when we borrow money.

Two factors work together to determine the supply of a product, service, or resource: the cost of producing it and the selling price.

Suppose buyers are willing to pay more for a product than it costs to produce it. Businesses usually increase their production to increase their profits (or their return over and above production costs). This *profit margin*, if it is large enough, encourages new businesses to enter this field. Now there's more competition among sellers, which tends to reduce prices or improve products or both. And it means a larger supply.

There is an opposite side to this point. Consumers might decide a product is not worth its price and stop buying it. The product is no longer worth the cost of producing it. When this happens, and if the situation continues very long, the product is forced off the market.

What is going on is a balancing act between the supply of goods and services and the demand for them in the marketplace. Prices play a role in this process. Look around and you can see the effects. When the auto model year is over, last year's models are usually reduced in price to stimulate sales. Department stores hold clearance sales to reduce their inventories.

Food prices go up and down, depending in part on the relative supply of agricultural commodities. However, the costs of such commodities are often a small share of the final retail price for many processed foods. For example, it was recently estimated that prices of farm products accounted for only about 8 percent of the price of a typical loaf of bread. The other 92 percent was for processing and distribution.

All these transactions between buyers and sellers are made possible by the existence of money. Using money is a convenient way to exchange goods and services. Also, by saving money, we can set aside some of our purchasing power for later use. Money makes buying and selling easy and thus makes our economic life far more productive. That is why money has replaced the barter system in all modern societies.

The marketplace is wherever these transactions occur, where buyers and sellers come together to agree on the exchange of goods and services for money. Transactions permit buyers and sellers to influence each other and thereby largely determine what our economy produces and who produces it.

## Competition

Competition has always been of key importance in the American economic system. The vitality of the

American economy is based on competition between producers. Those who supply the best goods and services at the best prices generally are the most successful. Competition is one of the factors that cause our economy to change constantly. Producers tend to move to activities where earnings apparently are higher and leave those where earnings are lower. This means workers, facilities, and raw materials shift to these new areas from former ones.

In any discussion of competition, the subject of productivity is likely to come up. Productivity describes how well producers (and governments) use resources—people, facilities, and raw materials. The most important factors influencing productivity are:

- People—their skills, efforts, and motivations.
- Capital resources—the availability and efficiency of factories and equipment.
- Technology—the application of science to industrial needs, involving new materials, new methods, and advanced processes.
- Organization—the effectiveness of management in combining resources.
- Government regulation—the imposition of standards or restrictions.
- Working environment—as it relates to both health and work attitudes

Improvement of productivity in business and industry is essential if we are to maintain competitiveness in selling goods and services both at home and abroad. Since our various governments normally have no competition in providing many of their services, improving productivity in government should be a matter of special interest and concern to us all. How do we as producers remain competitive? And how do businesses and industries increase productivity? Investments in new factories and equipment and improved technology are the answers in many cases.

## Balancing the Economy

As you probably realize by now, an important factor making the American economic system work is the law of supply and demand. It is not really a law, of course; it is an explanation of the factors determining how much of each product and service is produced and how those goods and services are distributed.

Remember that when we buy less than our economy is producing, eventually production goes down and unemployment increases. However, on the other side when our purchases increase, this demand results in business expansion and higher employment.

Supply and demand forces ultimately determine the levels of production and employment in our

economy. But as we shall see, certain steps can be taken to influence what these levels will be. It is now a responsibility of the federal government, as established by the Employment Act of 1946, to *promote maximum employment, production, and purchasing power.*

Maintaining both stable prices and high employment, however, is difficult in a free society. Wages tend to increase when available workers are in short supply, and prices of goods tend to rise when demand outstrips supply. Over the years, our economy has grown at a remarkable rate. But in this process, there have been periods of expansion and periods of recession. These alternating ups and downs mean our national goal of high employment is not always achieved.

The economy expands and contracts as a result of changes in our total spending. Many factors can cause

this, including the introduction of new technologies, the availability of investment funds, changing national economic policies, crop failures, wars, and public confidence in our economic future. There are many more. All these factors directly affect the economy.

Let's consider this matter of public confidence a little further. When economic times are good, individuals, businesses, and many governments feel more confident about the future, and they spend more. An individual might buy a new car or decide to buy a home. A company might decide the time is right to build a new factory or install new equipment. A local government might build a new school. Expenditures such as these are not made every day. When spending occurs in surges of increased public confidence, this stimulates the economy for a period of time. When such spending decreases, it normally slows down the economy.



## PART II

### QUESTIONS FOR DISCUSSION:

1. Why is the role of the CONSUMER said to be the key role that makes everything work in our economic system? Do you agree?
2. How are the concepts of SUPPLY and DEMAND important to our understanding of our economy in the United States?
3. What is the role of the PRODUCER in making our economy work?
4. Who are the PRODUCERS in our society? What is PRODUCTION in the economic sense? Are GOVERNMENTS producers?
5. How is GOVERNMENT involved in our economy today? How does it get into the decision-making process? Is the role of government more important today than earlier in the history of our country? Why?
6. What factors determine the SUPPLY of a product or service?
7. If buyers are willing to pay more for a product than it costs to produce it, will producers likely increase their production? Might this result in more competition? What might this then do to prices? To the product quality? To the product differentiation?
8. How is COMPETITION important in the MARKETPLACE of our American economic system? What is it? How does it operate?
9. Is PROFIT good or bad? Why or why not?
10. In what industries is our nation strongly competitive in the world markets? Why?

### IDEAS FOR FURTHER STUDY AND TOPICS FOR TALKS OR DEMONSTRATIONS

1. Select one natural resource or raw product and find all the final consumer goods which use that raw product.
2. Help your group plan a visit to a local business.
3. Examine the changes in one product over time. For example, how has one car changed over time? What changes have occurred in orange juice during the last 30 years?
4. Discuss the intermediate (value-added) processes the raw product goes through.





## Part III:

# The Role of Government in Our Economy

*“Government’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving regulate it. And if it stops moving, subsidize it.”*

—Ronald Reagan

Government units (on the federal, state, and local levels) are involved in five major areas of the economy.

1. Protection of the rights and freedoms—economic, political, and religious—of individuals through our courts and the administration of our laws.
2. Providing goods and services in the interest of all of us—such as highways, national defense, and education.
3. Regulation—the promotion of fair economic competition and the protection of public health and safety.
4. Promotion of economic growth and stabilization—through various economic policies and programs.
5. Direct support to individuals—programs to reduce hardships for individuals who cannot meet their minimum needs because of special circumstances or lack of employment.

Before we discuss the role of government in our economy, some definitions are in order. We should know the meaning of these important terms.

## SUPPLY OF MONEY

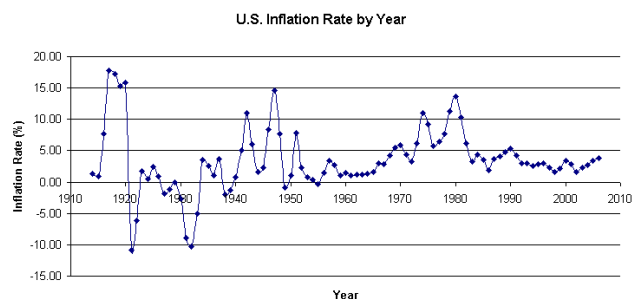
The supply of money has an important influence on spending and production, and banks play a central role in this process. By changing the money supply, the Federal Reserve affects the amount of money banks can lend to individuals and businesses to spend. In simplest terms, the Federal Reserve generally makes money more available when total spending is considered too low and less available when total spending is too high. These actions directly influence interest rates throughout our economy. The federal government does not directly control the supply of money in the United States. The Federal Reserve Board, appointed by the president and confirmed by Congress, controls the Federal Reserve System, which controls our money supply. Terms for members of the board do not coincide with presidential elections and are not supposed to be political appointments.

## INFLATION

Inflation means a continual rise in the general level of prices. Nobody wants inflation, but it has become all too familiar in the world today. Prices of most goods and services have increased significantly over recent years. Prices often go up as the quality of the goods and services we buy improves. But, in general, price increases not accompanied by improved quality are called inflationary. When inflation occurs, each dollar we have buys fewer goods and services. In the years between 1950 and 1975, the ability of our dollar to purchase these things went down by about 50 percent. However, from 1950 to 1994, the overall rate of inflation declined from 4.2 to 0.68 percent.

Inflation has at least three basic causes. When consumers, businesses, and governments spend too heavily on available goods and services, this high demand can force prices up. If costs of production rise and producers try to maintain profit levels, prices must increase. The lack of competition among producers also can contribute to inflation. The burdens of inflation tend to fall more heavily on those who live on incomes that remain the same or rise more slowly than prices. This can include many workers and retired persons. The only way these people can cope with rising prices is to buy less, reducing their living standards.

These economic ups and downs have varied widely in the past, and federal government policies often have attempted to moderate their adverse impacts. However, so many complex forces are at work in our economy, and the timing of government policies is so critical that unexpected results can occur.



## FISCAL POLICIES

The taxing and spending policies of the federal government are called *fiscal policies*. Federal spending can be increased to keep overall demand at a high level if private spending is low. And federal spending can be restrained to reduce overall demand when demand is higher than our total production.

Government tax policies also can be changed to help balance the economy. Federal tax cuts and rebates can be used to stimulate the economy in a recession—or tax increases may be used to help dampen excessive demand. Whether the federal government has a surplus (spending less than taxes) or a deficit (spending greater than taxes) depends on how fiscal policy is used to meet the needs of the economy and how the economy performs.

## MONETARY SUPPLY

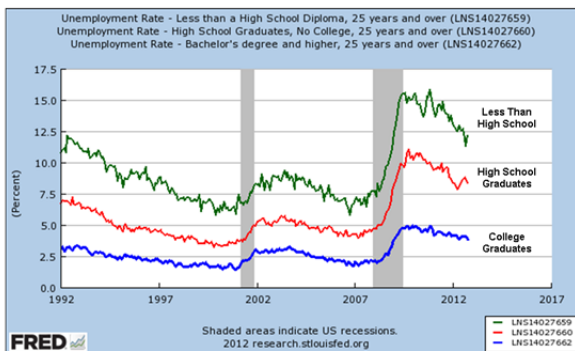
The Federal Reserve System has responsibility for controlling our nation's money supply—the total of all coins and currency in circulation, plus checking accounts held by individuals and businesses. This control is called *monetary policy*, which is another way to lessen the adverse effects of economic swings.

## EMPLOYMENT

The American economy has shown an impressive ability to create new jobs. However, the natural growth and development of the economy has brought major shifts in employment. Some regions of the country grow faster than others. The pattern of available jobs keeps changing, and the work force must continually adjust to these changes.

Of course, the total demand for goods and services changes during swings in the economy. This change in demand, combined with the regional and occupational shifts in employment just described, causes part of the work force to be unemployed for various periods of time.

U.S. Unemployment Rate by Education Level (Age 25+)



Reducing unemployment and the personal hardships associated with it involves efforts by business, labor organizations, government, and individuals themselves. Retraining programs, income assistance, and employment services can all help people adjust to changing job conditions.

## THE EVER PRESENT HAND OF GOVERNMENT

The U.S. government has far-reaching power over the American economy. It influences virtually every economic decision made by business managers and their employees, by savers and consumers, by investors and retirees.

To begin with, the government makes possible the working of the capitalistic economy. It provides the basics: money and credit for economic transactions, the judicial system that protects private property and enforces contracts, and regulators who keep competition on the up and up.

Beyond that, the Washington bureaucracy operates America's biggest business. It employs more people, buys more products, owns more real estate, constructs more buildings, insures more investments, and borrows more money than any other organization in the non-Communist world. Add in the state and local governments and you have an enormous machine that directly affects the whole economy.

Of equal importance, the government intervenes in the market by setting the rules under which all businesses compete. Through the tax system, the budget process, and control of the money supply, the government has great leverage in pushing the level of economic activity up or down.

Overall, the supply-side policies of the early 1980s had the effect of emphasizing the short run over the long run and eroding the foundation of the economy. At the core of these supply-side economic theories lies the key assumption that the stimulus given to the economy from tax cuts is strong enough for the tax cuts to pay for themselves. But most experts think otherwise, and experience has proved them to be right. While the short-term improvement in living standards cannot be denied, the long-lasting effect has been a ballooning of the federal budget deficit which leads ultimately to a deterioration of the long-term strength of the economy.

The economic power of the government, however, will never shrink to its original level, which was simply to coin money, regulate international and some interstate trade, and provide a few basic services, such as protection, roads, and defense. Generally, the economic activities assumed by

government were those that could not be carried out by private business.

The first major interventions by government into the economy were pushed by businessmen to make more commerce possible. In the 1800s, for example, federal investments were made in railroads, canals, and roads to make it easier to transport products to markets and to help build and populate new communities on the frontiers. The economies of the western territories were given a base by the federal government when it offered land to homesteaders, encouraging families to settle and farm there. At the same time, big business, interested in making the marketplace operate in a rational manner, pushed for government regulation of banks, credit, and the circulation of paper money. Starting in the late 1880s, Americans became more and more convinced that the free working of the market system was an insufficient guarantee that there would be no abuse. Complaints of farmers about unreasonable shipping rates, of workers about the employment of children, and of small businesses about ruthless, unfair competition by large firms all prompted government to step in.

As long ago as 1890, Congress passed a major piece of legislation regulating business—the Sherman Anti-Trust Act. The objective was to prevent two or more persons from getting together to restrain trade. This could involve forming a monopoly, where a single producer dominates an industry so that it can set prices or control supply without regard to competition. It also could involve price fixing, the agreement among several firms to set prices to avoid competition.

Competition may not be in the public interest in some cases. An example is a public utility that supplies electricity, natural gas, or water. Duplication of local power, gas, or water lines could result in higher rates. But if there is no competition, how should prices be determined? In such cases, state or local governments regulate the prices of the services, keeping in mind the interest of the public and the costs involved.

Still, until the Great Depression of the 1930s, the feeling remained strong that the capitalistic system generally was self-adjusting: given time, companies that sold shoddy merchandise at exorbitant prices would lose their markets; firms that mistreated workers would find poor morale cutting productivity and profits in their factories. The hard days of the Depression, however, prompted increasing political demands for regulations. Now more than 60 federal agencies include some kind of regulatory activity involving agriculture, food processing, consumer safety, worker welfare, or other activities closely related to agribusiness. Seventy-five years ago, there were just six.

Today, government rules cover deceptive business practices; the ingredients of foods, drugs, and cosmetics; the air Americans breathe; and the water we drink. State commissions usually set rates for electricity and natural gas. Local boards establish fares for taxis and public-transit systems.

Federal regulations detail eligibility requirements for government-sponsored medical care and outline how depressed areas are to be rebuilt. They specify minimum wages and tell employers how safe factories and offices must be. Rules cover insuring banks, distributing energy, overseeing radio and television, and mediating labor disputes.

All of these rules have costs far beyond the amounts needed simply to administer them. The Competitive Enterprise Institute found that it costs \$1.8 trillion which is more than half of the annual budget to regulate these rules. Most of that expense is picked up by consumers. For example, when an industry spends \$20 billion a year to meet federal clean air requirements, that expense later shows up in higher utility bills to consumers as electric companies act to recover their costs.

The climate of change toward deregulation has made little reduction in the overall cost of federal intervention so far, according to the Washington University center. But it seems certain to alter the way the economy works in affected industries. The major example to date is the airline industry. In 1980, the rules for entry of new companies, scheduling, and ticket costs were relaxed. More low-cost carriers jumped into the field, ticket prices dropped, and a new competitive era opened up.

The biggest, most powerful tool for influencing the economy came with the passage of the federal income tax law in 1913. To some extent, this progressive tax redistributes wealth, because those with higher incomes are taxed at a steeper rate than those down the income scale. Changes in tax rates have been used to fine tune economic activity. Lowering tax rates puts more spending money in consumers' pockets, increasing demand for goods and services during periods of sluggish growth or recession. At the same time, the government pumps money into the economy through the federal budget, trying to keep business expanding fast enough to provide jobs for all who want them but not so fast as to ignite an inflationary binge. When Washington buys something or hands out money, recipients have that many additional dollars to spend, thus increasing the demand for goods.

The federal government gives tax credits to companies to induce them to invest in new plants and equipment and to persuade them to train the unemployed. It uses tax deductions to encourage such industries as home building and to promote

such social and economic goals as energy conservation.



Uncle Sam also is in the lending business in a gigantic way. Billions are dispensed in loans to farmers, small businesses, and foreign buyers of U.S. exports. Additional billions of loans are guaranteed by the government.

Through Social Security, income maintenance, and other aid to the aged, the ill, and the poor, the government is a major source of funds for millions of Americans. For example, in 1991, approximately 24 percent of gross domestic product was allocated for Social Security. In 1994, Social Security payments totaled \$814 billion. Do you know what it was last year? If changed, what do you attribute this to?

The federal government also is the largest single customer for America's industrial products and services. The Pentagon alone spent more than \$1.7 trillion in 2012, with many billions going to buy everything from aircraft carriers to kitchen pots.

Directly or indirectly, the government supports much of the research done in the country. Most of the money these activities take is supplied through taxes. Federal, state, and local governments use revenues amounting to more than 22.9 percent of the country's total production of goods and services.

## Effects of Debt

Most often, the federal government has spends billions more than it takes in. To make up the difference, the Treasury will borrow—which is why the national debt goes up. To cover this deficit, the government sells securities to banks or individuals, thus taking for public use funds the lenders could have used to buy or invest elsewhere. In the past, this process has tended to increase the country's money supply. When the money supply increases at a pace faster than the output of goods and services, the result is likely to be inflation, with prices rising and wages racing to keep up. The major burden falls on persons whose incomes do not go up as fast as inflation and who thereby lose purchasing power.

## ECONOMIC THEORIES THAT VIE FOR DOMINANCE

For some 40 years, the theories of British economist John Maynard Keynes dominated the political economies of the United States and many nations of the non-Communist world. Over the past decade, those



John Maynard  
Keynes

theories, which hold that the active use of government taxing and spending powers can bring full employment and price stability, have come under increasing challenge. The reason is that they didn't work well during the decade of the 1970s, when inflation persisted during recession. That wasn't supposed to happen. In the Keynesian world, inflation should have dropped sharply during recession.

As a result of this unexpected development, other economic theorists have come into prominence. They include:

- Monetarists, think that a steady, restrained growth of the money supply is far more influential than budget policy on economic performance, inflation, and unemployment.
- Supply siders, who favor incentives to the economy by cutting taxes to stimulate work, savings, and investment.
- Post-Keynesians, who now acknowledge the potent effect that money and finance as well as federal fiscal policy have on the economy.

Let's take a closer look at the schools of economic thought now vying in the United States and some of their leading lights:

### Keynesians

The early interpreters of Keynes adopted budget activism as the way to manage the economy. To pull out of a recession, the government should create deficits, either by increasing spending or lowering taxes. Conversely, to cool down inflation, the government should accumulate surpluses, either by cutting spending or raising taxes. The original Keynesians believed in a predictable trade-off between unemployment and inflation. A higher inflation rate must be accepted to keep unemployment down, and vice versa.

Franklin Delano Roosevelt's New Deal embraced the Keynesian philosophy to lift America from the Great Depression when 25 percent unemployment was the nation's concern. During the 1960s, the Keynesians thought they could manage fiscal policy (government taxation and spending) to moderate, if not get rid of, the boom and bust swings of the business cycle.

But the Keynes formula ran into trouble in the 1970s when unemployment stayed high and inflation rose—a condition known as *stagflation*. Critics now believe that the Keynesian emphasis on spending and taxation through the federal budget overlooked the powerful effect money and credit has on economic performance, particularly in coping with inflation. Out of this criticism have come various post-Keynesian schools, which acknowledge that monetary policy (levels of interest rates and growth in the supply of



money) matters as much as fiscal policy in managing the economy's ups and downs.

In addition, many post-Keynesians favor some sort of an *incomes policy*—using the tax system rather than direct federal controls—to moderate wages and prices in the fight against inflation.

## Monetarists

Milton Friedman is the recognized leader. He contends that stable monetary policy, rather than activist budgetary policy, is the key to a smooth running economy. Inflation, Friedman argues, can be controlled only by maintaining a firm grip on the growth of the nation's money supply.



Milton Friedman

It is largely on the basis of this theory that the Federal Reserve Board in October 1979 switched from a policy of managing interest rates to one of controlling money-supply growth, letting rates find their own level.

As inflation is tamed, the monetarists contend, the economy will surge forward if it is unleashed from what they consider the shackles of government. That requires lower taxes, less regulation, and a reduction in the federal budget as a share of the total economy.

Unlike the Keynesians, Friedman and his followers do not think fiscal policy (federal taxes and spending) should be used to counteract the turns of the business cycle. These monetarists want to contain federal spending and balance the budget over the course of a business cycle. The government cannot fine tune the economy to eliminate every up and down, Friedman says. Its attempts to do so have made the ups and downs worse, not better.

## Supply-Siders

These are divided into political and academic advocates. Representative Jack Kemp (former United States Secretary of Housing and Urban Development) was the leading proponent of supply-side economics in the political arena. He argued that deep cuts in personal and business taxes would produce such a strong recovery that the budget could be balanced with rising revenues and without substantial spending cuts.

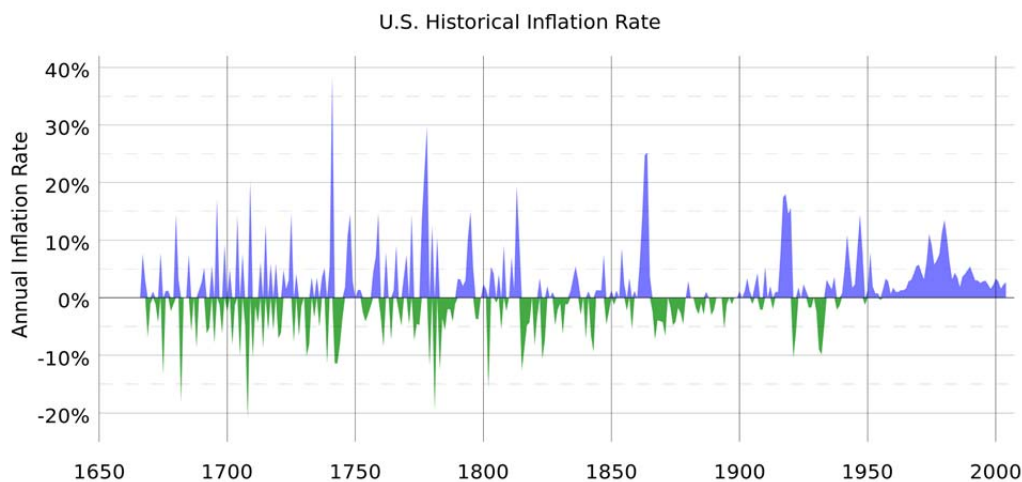
## Rational Expectations

Another current development in economic analysis, one that is influencing both monetarists and Keynesians, is known as rational expectations. Economists doing research on this theory attribute the failures of past government policy, in part, to the erroneous assumption that people would behave under new policies as they did under old ones. "*The government was assumed to be systematically smarter than people,*" explains Thomas Sargent, a professor at the University of Minnesota. When people behaved in unexpected ways, he adds, the objectives of government policy often were frustrated. Now these academics are attempting to include in their statistical models of the economy estimates of the rational expectations of people in reaction to policy.

Though this effort is far from complete, the hunch among the theorists is that the results will tend to support stable economic policies over activist ones. Says Robert Lucas, a University of Chicago professor, "*The best climate we know how to provide is stability.*"

This section has set forth some of the most important economic questions facing our nation today. How can we best encourage competition? How can we best deal with the problems of inflation?

In what ways can we broaden employment opportunities for those in need? Each deserves serious thought because our future progress depends on the answers we provide.



<https://en.wikipedia.org/wiki/Inflation>



## PART III

### QUESTIONS FOR DISCUSSION:

1. While ours is basically a capitalistic system with resources owned primarily by individuals and businesses rather than government, in some important respects ours is mixed economy existing within a democratic political system. What are some examples?
2. Are private property rights important in our business system? What are these? How are they established and maintained? What are some of the challenges to them today?
3. The allegation is sometimes made that government doesn't produce anything, only individuals and businesses engage in production. Is this true? Is it helpful in understanding the role of government in society?
4. Should government insist on every business surviving or perishing on its own merits, so long as it does not violate the laws of the land? Are there any exceptions to this? What are the considerations?
5. Can you recall recent examples of government BAILING OUT some large business or businesses? What circumstances are said to sometimes justify this? Do you agree?
6. Should government ever SUBSIDIZE or PROTECT business development? Has this been done to any considerable extent in the United States over the years? What about the great land grants to the railroads? What about import quotas or tariffs to protect infant industries in this country? What about special tax breaks? What about provisions for accelerated depreciation and others?
7. In general, there seems to be some feeling against BIG government and against BIG business in the country today. Why? Is it likely that we shall see a reduction of government's involvement in the future? Why? How big is too big—in government and in business?
8. The charge is sometimes made that in America we are more concerned with PROPERTY RIGHTS than with personal rights or human rights. How do you respond to this statement? Do you agree or disagree? What is the evidence on each side of the question?
9. Do you feel that the government and its employees have any ethical responsibilities to the general public?
10. What do you feel the government's role should be in the health care debate and other special issues?

### IDEAS FOR FURTHER STUDY AND TOPICS FOR TALKS AND DEMONSTRATIONS

1. Trace the history and activities of a United States government agency such as United States Department of Agriculture or other government agency.
2. Develop your own criteria for how one of our government agencies should function. For example, what should the Environmental Protection Agency do? Or how should we handle food stamps?
3. Conduct a survey of your community to see how many government agencies there are and what businesses, if any, they relate to. Draw a chart to show these relationships.



## Part IV:

# How to Do Business

“A business that makes nothing but money is a poor business.”

—Henry Ford

## WAYS OF DOING BUSINESS

### Introduction

After studying Parts I, II, and III, you should have some idea of how our economy works—in a broad sense. You should be aware of how the U.S. private enterprise system resembles other economies and how it is different. The different roles you play as consumer, producer, and the voice of government also should be apparent to you now. The remainder of our project on the American Private Enterprise System is devoted to examination of the producer, concentrating on the four different ways of doing business:

- a) the *individually owned business*,
- b) the *partnership*,
- c) the *corporation*, and
- d) the *cooperative*.

An overview will be presented first; then the next three units will be devoted to each method of organizing as a business. Table 1 on page 22 is a comparison of the methods used by these four types of businesses.

### Overview

**Business Organizations.** Businesses are organized to (a) produce or manufacture, (b) distribute, or (c) sell goods and services. Sometimes a business combines more than one function. For example, storekeepers buy, store, and sell goods. They may also sell a service, such as fixing television sets. Storekeepers seldom produce or manufacture.

**Production of Basic Commodities.** Some businesses produce basic commodities. Basic commodities are raw goods or materials. Consumers use some commodities, such as coal and oranges, directly. Farming, fishing, lumbering, and mining are businesses that produce raw products.

**Processing or Manufacturing.** Typewriters, tractors, bread, canned peas, baby bottles, radios, and televisions are made from basic commodities. Processors make basic commodities more useful to consumers. Cooking peas and canning them is processing. Manufacturers use basic commodities to make other things. Radios are manufactured.

**Marketing.** Products that are processed or manufactured must get to us as consumers. Marketing involves selling and transporting products. Sometimes products are sold to wholesale firms first. Then wholesale firms sell products to retail firms, and retail firms sell them to consumers.

**Business Services.** Many businesses sell services instead of products to people or other businesses. Banks, law firms, doctors, bowling alleys, and repair shops sell services.

### How Do Businesses Produce?

A business produces using two or more of the following elements:

- Natural Resources
- Labor
- Capital
- Management
- Government

As an example, consider a gas station and auto repair shop. No matter who owns it, it needs:

**Basic Natural Resources.** The land for a gas station and repair shop must be in a good spot. It should be easy for cars to drive to it. A good supply of water is necessary. In addition to these two natural resources, other services such as electricity and telephone must be available.

**Capital.** The land, money, buildings, machines, and tools used in a business represent the capital used or owned by the business.

**Labor.** Businesses need labor to keep them functioning. For example, a full-service gasoline station needs a skilled mechanic, a gas-pump attendant, and a bookkeeper. The working conditions and the abilities, skills, and attitudes of owners and employees determine in part how well the business will operate.

**Management.** Even with good capital, labor, and natural resources, someone must run the business. That is called management. Managers (or entrepreneurs) solve problems, decide who does what, and plan. Management at a gas station may solve a problem of long lines of customers by buying more land, adding more pumps, or hiring more people. It is poor management, for example, to use a skilled

mechanic to wash cars. Management must also see that gasoline, tools, and other materials are available.

**Government.** Businesses need police and fire protection, mail delivery, and other services. Local governments furnish some services, such as police protection. State or federal government furnishes services, such as inspecting buildings and equipment for safety.

**Capital Goods.** Factories and machinery needed to convert raw materials into the goods and services we want are called capital goods. Factories and equipment wear out or become out of date and noncompetitive. Besides replacing these items, more capital goods are needed if production is to expand. Without a continuing supply of new capital, the economy cannot produce the goods, services, and jobs required now and in the future. And this means large capital investments must continually be made.

In addition to replacing, modernizing, and expanding existing industrial capacity, our nation will be challenged in the next decade to provide more jobs, expand housing, develop major new energy resources, continue improvements in the quality of our environment, and improve our transportation networks. It has been estimated that our total capital requirements for the next 10 years will at least double those of the past decade.

Capital goods are important to jobs. The investment in equipment and facilities is many thousands of dollars for each production worker in American industry. Millions of new jobs will be needed in the near future for workers entering the labor market for the first time. Here we face some very important questions. How can business and government best work together to provide these jobs? And how will the necessary capital goods be provided?

## Businesses Contribute to a Community

Business provides our basic needs:

**Food.** The food in a grocery store comes from many business organizations. Milk, for example, is produced on farms. Then it must be processed and put into containers before it can be delivered to stores. Farmers also buy cows, feed, and many other things from different businesses to help produce the milk.

**Shelter.** Many materials are used in building houses. For example, nails are manufactured from metal. First, ore is taken from the mine to the smelter for processing. Metal is then taken to a factory where the nails are made. Nails are marketed by factory representatives to wholesale firms. Wholesale firms sell nails to retail stores.

**Clothing.** Ready-to-wear clothes and cloth for making clothes are bought in stores. Tailors provide a service in making or fixing clothes.

**Transportation.** Transportation services move people or products from place to place.

**Communication.** Communication takes many forms, a number of which involve business: television, radio, newspaper, telephone, computer, and on and on.

**Services.** Personal services make a community safer and more comfortable. Banks, insurance companies, law offices, churches, schools, and hair salons are examples.

Successful local businesses offer two benefits to the local community: (1) they serve the community and (2) they generate income. Successful businesses are necessary for a prosperous community.

Local businesses usually trade with organizations outside the community; just as local government works with county, state, and federal governments.

## Starting a Business

No matter what its present size, chances are that an enterprise traces its roots to an entrepreneur—a person with a new idea who took a risk in the hope of making a profit.

The examples are endless. In 1976, two college dropouts—Steven Jobs and Stephen Wozniak—raised \$1,500 by selling an old Volkswagen van and setting to work in a garage to design the first line of personal computers. Now, their company (*Apple Computers*) is one of the leaders in the field.

Others build their business around existing ideas combined in a new way. For decades, many Americans paid consultants to figure their income taxes, but it took Henry and Richard Block of Kansas City in the mid-1950s to develop a lucrative nationwide chain of tax-preparation offices aimed at individuals of all income levels.

Even in these risky times, entrepreneurial spirits seem to thrive. During a recent recession, in 2008, an average of 320 out of every 100,000 adults started a business which represents about 530,000 new businesses a month.

## Making a Profit

In order to stay alive, a business must have profits to pay for future expansion, unexpected events, and as incentive to the owner to keep going. In a corporation, profits also are the source of dividends paid to the individual owners—the *stockholders*.

While there are many ways to measure profits, investors frequently look at two. One—the *profit margin*—is the amount a business clears on each dollar of sales. A supermarket, for example, typically has a profit of a little over one cent on each dollar of

sales. The second measure is the return on investment, or profit, in relation to the net amount investment in the firm.

Thus, while annual reports might show rising profits in dollar terms over several years, a look at these other two measures may show a slowdown or even a decline depending on inflation rates.

Since 2011, inflation rates have continued to drop. In 2011 inflation rates were sitting at 3.0% but dropped in 2012 to 1.7%. In 2013 and 2014, the inflation rate has remained at 1.5%.

## The Problems of Productivity

In the struggle to boost profits and trim costs, companies are focusing more and more on productivity—*usually output per worker per hour*.

Historically, the productivity rate has risen by almost 3 percent per year in the United States. But beginning in the mid-1960s, the rate in this country began to slow dramatically. At the same time, other nations, Japan in particular, have shown steady jumps in productivity. Productivity in the United States over the last decade has been up and down. For example, in 2003 the productivity rate was at 3.7% but was down to 0.9% by 2006, in 2009 the rate went back up to 3.2% but was down in 2012 to 1.5%.

Some experts blame this problem on the flood of inexperienced workers into the labor market. Others cite the failure of many U.S. firms to invest in enough modern equipment and plants, a problem that often can be traced to inflation and the high cost of borrowed funds.

With more money to invest, companies are expected to move more rapidly into such innovations as industrial robots, which can speed production, improve quality, and relieve people of tedious and dangerous jobs.

In addition, more and more computers, word processors, and other automated equipment are appearing in factories, offices, banks, department stores, and even supermarkets. Many firms also are setting up quality-control circles in which small groups of employees give their ideas on how to trim costs and boost production.

Together, these efforts are designed to produce an item for less, thus allowing companies to make more profits and be more competitive with foreign firms.

## A TOPSY TURVY INVESTMENT WORLD

Nowhere is American capitalism in greater turmoil today than at its core—the *financial system that puts money to work to make more money*.

Unstable rates of inflation during the past decade turned the nation's money markets topsy-turvy; escalating prices eroded corporate earnings, discouraging thousands of investors from acquiring shares in corporations. Many would-be entrepreneurs were unable to form new companies, while existing firms had to shelve plans to expand operations. In today's economy, many of these trends have been reversed with interest rates dropping. The number of homeowners has increased, the market has grown, and it is a great time to be an entrepreneur.

Wide swings in values of traditional investments such as stocks and bonds make it harder for securities firms, banks, and other financial institutions to attract savings. The results: an explosion in investment opportunities tailored to inflation savvy investors.

Why are these changes so important? Put simply, our economy relies on the financial markets to funnel people's savings into industrial expansion. Without an efficient investment process, economic growth would be impossible.

## Raising the Money

All these steps—*starting a business, making a profit, and increased productivity*—take money, which in today's marketplace is becoming ever more difficult to raise, especially with the government's tremendous demand for borrowed funds.

Traditionally, corporations have relied on the sale of stocks to raise money for growth and expansion. Perhaps a good place to start this discussion is to respond to a few basic questions. What is stock? Why does a company issue stock? Why do investors pay good money for little pieces of paper called stock certificates? What about bonds? As stated above, a company may need money for growth and expansion. One option is for the company to issue stock. There are other methods, too, such as issuing bonds and getting a loan from a bank. However, stock raises capital (money) without creating debt, without creating a legal obligation to repay these funds. Buyers of the stock become shareholders in the corporation—the company's owners. From their investment, these shareholders expect to make a good return on their investment. Bonds, too, are an important capital source for corporations. In normal years, the aggregate value of new bond issues may be five times greater than the value of new stock issues. In fact, in the modern era, American business has raised little more than 5 percent of the money it has needed through the sale of stocks. It has raised most of the balance by selling bonds. This is why the bond market is many times larger than the stock market.

## In the Driver's Seat—the Board of Directors

While thousands of individual investors may own a piece of a large public firm, its real control is in the hands of a board of directors.

Board members often include officers of the company, major stockholders or their representatives, and outsiders who can provide useful connections with law firms, banks, investment houses, and customers.

In recent years, some firms have broadened their boards beyond the typical white, wealthy, male membership to include women and minorities. In 1980, The Chrysler Corporation added the president of the United Auto Workers to its board, marking a dramatic shift in U.S. business-labor relations.

Although the board sets overall policies, the day-to-day decisions are made by professional managers trained in law, business management, engineering, finance, and other fields. Beyond their salaries, these managers may have no ties or loyalty to the organization, unlike the entrepreneur scrambling to make a firm a success.

Increasingly, top management is spending more time on outside issues that can have a big impact on the firm. Among them: government regulations, consumer demands, environmental rules, and competition from overseas.

Yet companies are beginning to realize that such issues—and the added costs they bring with them—should not be allowed to keep managers from their mission of putting out a product or service that people will want to buy.

## Stock Market

The stock market is the hub of the investment world. More than 40 million individuals own shares in U.S. corporations. When people purchase a company's stock, they actually become part owners, entitled to a share of the firm's profits.

Stocks can provide two sources of income for the investor. The first is the dividend—profits a firm distributes to its shareholders. The second is the capital gain an investor reaps when a stock is sold for more than its original price. However, investors have no guarantee that a stock will pay any dividends, and a share's value can easily decline.

Stock prices are influenced by many factors, including the value of a firm's assets, earnings prospects, and investor demand. That's why investors pay close attention to developments such as changes

in a company's product line. Even rumors can have dramatic impact.

Stock prices are a key barometer of the business outlook. A bear market—when prices are falling—indicates investors are worried that the economy is slipping and that corporate earnings will decline. In contrast, the rising stock prices of a bull market signal that investors think business conditions and profits will improve. Corporations could not sell a single share, however, if there were no stock market where investors in need of cash can easily sell their holdings

On a typical business day, more than 500 million shares change hands. More than half of these trades take place at the New York Stock Exchange. Called the Big Board, it lists the stocks for more than 2,800 of the country's oldest, largest, and best-known corporations.

The New York Stock Exchange had a daily trading value north of \$169 billion in 2013. The American Stock Exchange is also in New York and is the third largest trading floor after the NASDAQ. The American Stock Exchange options list is one of the largest in the world with over 1,700 options traded on stocks, American depository receipts, indexes, exchange traded funds, and holders.

For an idea of how a stock exchange works, note what happens when an investor decides to buy 100 shares of, say, the Widget Company for \$5 a share. The investor first asks a brokerage firm to handle the purchase. At the stock exchange where Widget shares are traded, the broker's representative locates another broker whose client wants to sell 100 shares of Widget at the same price. Once the trade is executed, the buyer has five business days to come up with the \$500 for the stock and the seller has five days to deliver the shares.

Some firms issue preferred stock that pays investors a fixed dividend. Dividends on this special class of stock must be paid before any earnings are distributed among other shareholders.

## Buying and Selling Bonds

When the stock market looks risky, many people prefer to invest their savings in *debt securities*, which usually provide a dependable flow of income.

Many companies and government agencies borrow money by selling bonds, typically in denominations of \$1,000. A *bond certificate* is an *IOU* that promises to pay the holder a certain rate of interest and to redeem the full face value of the note when it matures. Terms of new issues typically range from five to 40 years.

**Table 1. Comparison of Methods Doing Business in America by Different Types of Businesses**

Features Compared	Type of Business			
	Individual	Partnership	Regular Corporation	Corporate Form Cooperative Cooperation
Who uses the services?	Non owner customers	Generally non owner customers	Generally non- owner customers	Chiefly the member-patrons
Who owns the business?	The individual	The partners	The stockholders	The member-patrons
Who votes?	Not necessary	The partners	Common stockholders	The member-patrons*
How is voting done?	Not necessary	Usually by partners share in capitol	By shares of common stock	One member one vote or proportional to patronage
Who determines policies?	The individual	The partners	Common stockholders and directors	The member patrons and directors
Are returns on ownership capitol limited?	No	No	No	Yes, 8% or less*
Who gets the net operating proceeds?	The individual	The partners in proportion to interest in business	The stockholders in proportion to stock held	The patrons on a patronage basis*

\*Basic cooperative characteristics.

Bonds are considered less risky than stocks, since any interest obligations must be met before a dividend is paid. In addition, bondholders get first crack at the assets of a bankrupt firm.

Still, the price of a bond can vary greatly over its lifetime, depending on the course of interest rates. When rates fall, bond sellers can demand a premium.

In general, higher yields are offered on longer term bonds, since investors must commit funds for 20 years or longer. In the past this could change, but only if interest rates became volatile. Interest rates over the past couple decades have dropped.

Independent firms, such as Standard & Poor's or Moody's, evaluate an organization's ability to carry its debt burden before assigning a rating, which can vary from the top-quality triple-A rating to a single C or D for companies in default. To offset low-quality ratings, issuers must offer higher yields.

The taxing power of the federal government assures that its debt securities are virtually risk-free, so that the U.S. Treasury borrows more cheaply than do private corporations. However, the lowest bond rates are offered by state and local governments. While they don't share Uncle Sam's impeccable bond

rating, the interest they pay is exempt from federal income taxes.

### Hedging Bets

Soaring interest rates encourage the creation of various devices enabling investors to hedge their bets.

Today, investors can protect themselves against adverse movements in stock values by writing options to buy or sell a stock at the current market price prior to a future date. For example, an investor who fears that the price of his/her share in Company A will fall in the coming months can buy an option to sell the stock to another investor at the present price.

If the price falls before the option expires in the next nine months, the investor is able to sell the stock at the higher price. If the market price rises, the investor just lets the option expire.





Part V:

# Sole Proprietorships and Partnerships

*“Justice is the infrastructure of proprietorship.”*  
—Kemal Atatürk

## THE INDIVIDUALLY OWNED BUSINESS

Individual ownership is the oldest form of business. Individually owned businesses include farms, local stores, repair shops, barbershops, restaurants, dental practices, and others.

The sole proprietorship remains the most common type of company, accounting for more than 70 percent of all firms. Here, an individual stands alone, bearing full responsibility for the success or failure of the venture, such as permits and licensing. On a small scale, sole proprietorship illustrates many of the activities common to all business.

For example, perhaps your neighbor—a teacher—tires of the classroom. She knows from experience that private tutors are in demand. So, after sizing up her market, she quits school and opens a tutoring service.

At first, she does everything alone. Start-up money, or capital, for an office in her home and for study materials comes from her savings.

Through trial and error, she discovers what fees students are willing to pay, and she eventually earns enough to cover expenses and have some funds left over—*a profit*.

Profits might go to improve the business, perhaps to purchase a computer. Or she might take the extra money and hire another teacher if business is booming or spend more on advertising if it is slowing. Another portion of the profits may be set aside for future expansion or for unforeseen events. Some she keeps as a personal reward for the risks of establishing the business.

Later, a big injection of cash might be needed to open another office or add staff. She may decide to find partners to share costs and profits, or she might go to the bank or other sources of capital. Lenders usually demand a successful track record before they will make a loan to an individual.

In some cases, too, lenders or venture-capital firms that invest in growing businesses will demand a share of ownership. The result is that the entrepreneur gets money to expand but gives some of the control and profits to others.

1. The individual owner serves the public. The owner buys and sells goods or provides services to whoever wants them.
2. Little legal help is needed to start this kind of business. The owner may need to buy a license or apply for a permit. For example, a license to operate a barbershop or hair salon is all that is needed.
3. The owner provides or borrows capital to start a business and has the liability for all debts the store owes. If the store loses money, the individual still must pay the bills.
4. Management is the responsibility of the owner, although someone can be hired to operate the business.
5. The individual owner can make all decisions and determine business policies.
6. The owner receives the net margins, the money left after all bills are paid.
7. When the owner retires or dies, heirs may keep the business, sell it, or close it.

Below are some characteristics of individually owned businesses. Are they advantages or disadvantages?

- The business can be started quickly. Decisions may be made quickly, policies changed. The owner is responsible for management.
- Business credit is only as good as the credit of the owner.
- Large amounts of capital are difficult to obtain for business expansion.

Although some farms, even the family type ones, are now incorporated, the predominant type of farm business is industrial agriculture.

The individually owned business has these advantages: (1) it is easy to control—the owner’s judgment is final, and (2) any profits are the sole property of the owner—they need not be shared.

But it has these disadvantages: (1) any losses are borne by the owner—they cannot be shared, and (2) capital is limited by what the owner can put up or borrow—which often limits the size of the business.



## THE BUSINESS PARTNERSHIP

A *partnership* is a voluntary association of two or more persons, as co-owners, to carry on a business for profit. Property used in the business may be leased, but the business as an enterprise must be owned by all the partners. Partnerships are governed state law; most states, however, have adopted the Uniform Partnership Act, and additional rules may be adopted in the partnership agreement.

For federal income-tax purposes, the term “partnership” includes a syndicate, group, pool, joint venture, or similar organization carrying out a trade or business and is not classified as a trust, estate, or corporation. A joint undertaking merely to share expenses is not a partnership. Mere co-ownership of property maintained and leased or rented is not a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

### Creating a Partnership

A partnership is created by an oral or written agreement. In some instances, a partnership may be implied without an agreement if the business is being carried on as a partnership. Several characteristics define a partnership: (1) each person involved participates in management decisions; (2) assets are owned jointly, profits are shared; (4) losses are shared; (5) the parties operate under a firm name; (6) the parties have a joint bank account for doing business transactions; and (7) the parties keep a single set of business records.

### Legal Considerations

Listed below are some legal factors that partners, or potential partners, should consider.

1. Unless otherwise specified in the agreement, each partner legally has an equal voice in management control, and a majority of the partners must control business decisions.
2. Both real and personal property may be owned in the partnership name.
3. Profits and losses are divided according to the specific agreement; partners do not normally draw compensation for their services, and any withdrawals or wages should usually be treated as advances on their share of the profits. Profits do not have to be distributed on the basis of the relative amount of capital contributed to the partnership by respective partners.
4. A partnership must have its own records, especially for income tax purposes. Although the business pays no income taxes, a return showing partnership income tax information must be filed. The partners then pay individual

taxes on their share of the partnership income, as specified in the partnership agreement.

### Family Partnership

Members of a family can be partners. However, family members (or any other person) will be recognized as partners only if one of the following requirements is met: (1) if capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction, actually own the partnership interest, and actually control the interest *or* (2) if capital is not a material income-producing factor, they must have joined together in good faith to conduct business. In addition, they must have agreed that contributions of each entitle them to a share in the profits. Some capital or service must be provided.

### General Partnership

There are three types of partnerships: general partnerships, joint ventures, and limited partnerships. A general partnership is created when two or more individuals agree to create a business and to jointly own the assets, profits, and losses. There is no limit on the number or types of partners. A general partnership can be formed by an oral agreement. Even so, it is better for the general partners to have a written agreement that addresses a number of key issues, including the following: (1) how much time and/or money the partners will contribute to the business; (2) how business decisions will be made; (3) how profits and losses will be shared; (4) what will happen if a partner dies, becomes disabled, or stops working or contributing to the business; and (5) when the partnership will make payments to its partners.

In a general partnership, each partner is individually as well as jointly liable for all of the obligations of the partnership. It is important that general partners carefully evaluate the financial status of each other before forming a general partnership.

### Limited Partnership

A limited partnership may be created by following specific steps set out in each state’s statutes. Limited partners do not have personal liability for the business of the partnership. Limited partners are at risk only to the extent of the contributions that they agreed to in the partnership agreement.

### Joint Venture

Considered similar to a general partnership, a joint venture lasts only for a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

## Taxes in the Partnership

The partnership itself is not responsible for paying taxes on the income generated by the business. A partnership tax return is filed but for informational purposes only. Each partner individually pays taxes on his or her share of the business income. The profits and losses “flow down” from the partnership to the individual partners. Partners must also pay self-employment tax on their partnership income.

## Partnership Advantages

There are four real advantages in organizing as a partnership. First, partnerships are relatively easy to create without much legal expense. Second, a partnership permits ownership by more than one individual. Third, a partnership pays no income tax since profits are distributed to partners as ordinary income. Fourth, a partnership is easy to dissolve and has few legal formalities for its maintenance.



## Disadvantages of a Partnership

First, partnerships succeed only if each partner has faith and trust in the other partners' business abilities. Second, each partner is individually and fully responsible for all debts owed by the partnership; however, this does not extend to personal debts of the other partners. Third, the partnership ends with death, bankruptcy, or incapacity of a partner. Fourth, general partnership interest may not be sold or transferred.

## Terminating a Partnership

A partnership terminates when: (1) all of its operations are discontinued, and no part of any business, financial operation, or venture is continued by any of its partners in the partnership; or (2) at least 50 percent of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner. Any partner may terminate the partnership at will. Although a partnership is easy to terminate, careful thought should be given to this area at the same time the partnership begins.



## PART V

### QUESTIONS FOR DISCUSSION:

1. What are some businesses in your own community that are individually owned or partnerships?
2. How does the number of such businesses in your community compare with the number of corporations or cooperatives? Check with others.
3. If you had information as to the rate of failure among single-owner businesses and corporations, which would you think might have the *highest* rate of failure and why?
4. What are some of the advantages and disadvantages of the individually owned business?
5. What are some of the advantages and disadvantages of the partnership-owned business?
6. How does an individual get enough capital to begin a single owner business? What are some of the limitations? Why?
7. How many people must be involved in order for there to be a *legal* limit to the number of partners in a business partnership? What are some of the practical considerations involved in deciding on the number of partners in a business partnership?
8. If there are profits resulting from the operations of a business partnership, to whom do these profits belong? How are they divided?
9. Would you be willing to invest in a partnership business in some distant city? Why or Why not.

### IDEAS FOR FURTHER STUDY AND TOPICS FOR TALKS AND DEMONSTRATIONS

1. Invite a lawyer to tell your group how one starts an individual business or partnership in your county.
2. Look at the yellow pages of your social media outlet locally and try to determine how many individual businesses and partnerships are in your local community. Try to categorize them by type of business. Are individual businesses and partnerships usually among a certain type of business activity? Can you think of reasons for your findings?



## Part VI:

# Investor-owned Corporations and Limited Liability Companies

*“Never forget that you only have one opportunity to make a first impression- with investors, with customers, with public relations, and with marketing.”*

—Natalie Massenet

## CORPORATIONS

A third of all business organization is called the corporation. The corporation is defined as a legal entity separate and distinct from the shareholders who own it, from the individuals who manage it, and from its employees. There are four major kinds of corporations: a traditional corporation (or a “C” Corporation), an S corporation (named because of its organization meeting the IRS requirements to be taxed under subchapter S of the Internal Revenue Code), professional corporations, and non-profit corporations.

The corporation is considered a separate legal entity and, as such, shareholders in the corporation are not personally responsible for the losses of the business. As a separate legal entity, the corporation has most of the legal rights and duties of an individual. For example, the corporation can enter into contracts, transact business, hold property, sue, and be sued. It should be noted that it is the concept of legal separateness that sets the corporation apart from the partnership and sole proprietorship.

Most states also will recognize non-stock corporations, which are commonly used for non-profit organizations. There are no owners in a non-stock corporation, although there may be members.

### Forming a Corporation

Forming a corporation involves the transfer of money, property, or both by prospective shareholders in exchange for capital-stock in the corporation. Perhaps the first step in organizing a corporation is to define clearly the goals the corporation is expected to meet. The next step is to retain the services of an experienced attorney. The attorney will be instrumental in developing the articles of incorporation and other legal documents. A third step in forming a corporation is to engage a certified public accountant to set up record accounts. The remaining steps are to obtain a state charter; issue dividend stock as prescribed when goals were established; issue stock certificates; hold the first

meeting of stockholders; elect a board of directors and adopt the bylaws of the corporation; elect officers; set wages and salaries and settle on remuneration for assets leased to the corporation; and establish a fiscal year.

### Corporations’ Legal Foundation

An investor-owned corporation is established by the founders according to the laws of the state where the corporation is headquartered. Articles of incorporation or a certificate of incorporation explain the activities and purposes of the corporation. Information in the articles of incorporation includes: the name of the business, the total number of shares of stock the corporation can sell or issue, the number of shares of stock each of the owners will buy, the amount of money or other property each owner will contribute to buy his or her shares of stock, the business in which the corporation will engage, and who will manage the corporation.

Usually bylaws are adopted specifying how business will be conducted. Bylaws are really a set of rules of procedure by which the corporation is run. Such rules will include information on how to conduct the stockholder meetings and directors’ meetings, the number of officers in the corporation, and the responsibility of each officer.

### Who Owns the Corporation?

Corporations are owned by their shareholders or stockholders. Such corporations are commonly referred to as “investor-owned corporations.” An investor-owned corporation is operated as a profit keeping enterprise. Individuals are motivated to purchase share of stock in the corporation to make a profit on their investment. The corporation derives capital funds by issuing share of stock. The price of each share may vary from day to day.

Stock of many investor-owned corporations is bought and sold daily on stock exchanges, the largest being the New York Stock Exchange. Because we live in a global economy, stock markets in other countries such as Japan are of special interest to many stockholders.

## Stocks and Non-Stock Corporations

Stock corporations, as the name implies, are corporations that raise a large percentage of their capital through the sale of stock to stockholders. A stock corporation may elect sub-chapter S status for tax purposes. Once such an election is made, the corporation is referred to as a sub-chapter corporation.

## Capitalizing the Corporation

Corporations need long-term capital for buildings, facilities, and equipment and short-term capital to cover the day-to-day expenses. Some capital funds are obtained by issuing shares of stock to investors who are looking to make a profit. Corporations supplement this capital by borrowing from banks, other financial institutions, and individuals.

## Controlling the Corporation

The corporation is controlled by the stockholder(s) who own the majority of shares in the corporation. Stockholders' wishes are reflected by the actions of a board of directors who are elected by the stockholders. The board of directors is responsible for the major decisions of the corporation. The board will meet a minimum of once each year. Typically each director has one vote, and usually a majority vote of the directors is sufficient to approve a decision of the board. Once the board of directors is determined by stockholders, the officers of the board (president, vice-president, secretary, and treasurer) are elected by the directors from among their ranks.

The officers are responsible for running the day-to-day business of the corporation.

## Taxing the Corporation

The corporation must file its own income tax returns and pay taxes on its profits. The corporation must report all income it has received from its business and may deduct certain expenses it has paid in conducting its business.

Dividends paid to shareholders by the corporation are taxed to each shareholder individually. This process is often referred to as "double taxation." This is true because the corporation pays taxes on its profits, and shareholders must pay taxes on the dividends paid to them from the profits.

## Advantages of Corporate Structure

The major advantages of organizing a business as an investor-owned corporation are:

1. Liability is limited to assets of the same legal rights as an individual.
2. The corporation can operate in permanence, (continuity of operation).
3. It is easy to add additional owners or investors.

## Limited Liability

A corporation is treated as a separate entity from its owners. This suggests that creditors of the corporation may look only to the corporation and the business assets for payment. Individual stockholders are not personally liable for the losses of the business if the corporation is established properly. The extent of shareholders risk is their investment in the corporation.

## Continuity of Operation

A corporation exists for any length of time the shareholders desire, as long as it continues to fulfill the requirements of law. In other words, a corporation does not cease to exist if one or more of its owners dies. Ownership of a corporation can also be transferred by sale of all or a portion of the stock.

## Easy to Add Additional Investors

Additional owners can be added either by selling stock directly from the corporation or by having the current owners of the corporation sell some of their stock. This transaction can occur without any negative effects on the corporation.

## How Corporations Handle Risk and Uncertainty

One way an enterprise can survive in this riskier era is to become a larger and more diversified corporation. When one part of its operation falters, other parts may do very well, thus ensuring the overall health of the firm.

Corporations play the largest role in the American economy accounting for the largest portion of all business sales receipts, while single proprietors and partnerships account for a small amount.



[https://en.wikipedia.org/wiki/Corporate\\_tax\\_in\\_the\\_United\\_States](https://en.wikipedia.org/wiki/Corporate_tax_in_the_United_States)

What's behind this trend to bigness? For one thing, many of the products and services sold to people now are too complex to be produced by small enterprises. Size can also mean savings and greater efficiency than are possible on a small scale, from buying raw materials by the ton to mounting a mass sales-and-delivery campaign.

The corporate form of ownership also works better for ventures involving large amounts of money because of its limited risk. Legally, if a corporation goes bankrupt, the owners usually cannot be required to make good on unpaid debts.

What characterizes today's giant corporations is the constant search for the right mix. By moving quickly into the most profitable fields and phasing out products that offer little opportunity, a company can do very well, despite economic downturns.

This trend is reshaping countless firms. General Electric, for example, was known traditionally for its electrical and electronic equipment. During the early 1970s, 80 percent of its earnings came from such equipment. At latest report, this type of product, including consumer and lighting goods, was responsible for less than 50 percent of earnings. The remaining profits came from such things as information services, financial activities, aerospace, medical systems, power systems, transportation equipment, and energy exploration.

Investor-owned corporations have these characteristics:

1. Like the individually owned business and partnership, the investor-owned corporation serves the general public.
2. Capital for investor-owned corporations is usually provided by selling stock or by borrowing. Corporations may borrow from lending institutions. They can also issue bonds and pay back the people who buy the bonds. The corporation is responsible for debts. If the business fails, each owner of stock can lose only the amount paid for the stock. The corporation can lose its property or assets.
3. Business decisions and matters of policy are decided by the board of directors and officers, who are elected by stockholders. If stockholders wish to change policies, they can elect other directors at the next annual meeting. Each stockholder has as many votes in these elections as the number of shares he or she owns. Those who own the largest number of shares of stock control the corporation.
4. Management of the corporation is by the officers, who are selected by the board of directors in accordance with the charter.
5. Net margins are either divided among the stockholders on the basis of the amount of stock owned or used to expand the business.

The board of directors decides how net margins will be used.

6. When a stockholder dies, his or her stock goes to heirs, who may keep or sell it. Business operations are usually not affected.

Below are some characteristics of investor-owned corporations. Are they advantages or disadvantages?

- The purpose of investor-owned corporations is to make money for stockholders. The financial responsibility of each investor-owner is limited to the amount he/she has invested in stock.
- The investor-owned corporation is structured to continue in business indefinitely. Long-range planning and research can be conducted.
- Often, many owners of stock do not attend meetings. They can vote by proxy. Some owners of stock pay little attention to business operations. They are primarily interested in the dividends earned by the stock they own.

## LIMITED LIABILITY COMPANIES

A limited liability company (LLC) is a type of company authorized only in certain states, whose owners and managers have limited liability and tax benefits. An LLC is a blend of some of the best characteristics of corporations, partnerships, and sole proprietorships. It is a separate legal entity like a corporation, but it is entitled to be treated as a



partnership for tax purposes. Because it is a separate entity, none of its members are personally liable for its debts. But, like a partnership, the LLC is not a tax-paying entity. Profits, losses, etc. flow directly through and are reported on the individual tax return. It is very flexible and simple to run and, like a sole proprietorship, there is no statutory necessity to keep minutes, hold meetings, or make resolutions that can trip up many corporations.

### Forming an LLC

The formation of an LLC is not a difficult process. An LLC is formed by filing a form, usually called articles of organization, with the Secretary of State. Most states require that an annual report be filed to keep them up to date on the LLC's current status, but other than that, there are no other ongoing reports or forms. Most states require that the LLC have an

operating agreement. The operating agreement is the agreement between the members as to how the LLC will be managed, and it contains provisions that will qualify it for the beneficial partnership tax treatment.

### Who Owns the LLC?

The owners are called members and can be virtually any entity, including individuals, corporations, other LLCs, trusts, pension plans, etc. Unlike a corporation, which is not required to have more than one shareholder, most states require that an LLC consist of two or more members. Management and control of an LLC are vested in its members, and no one can become a member of an LLC without the consent of members having a majority in interest unless the articles of organization state otherwise.

### LLCs' Legal Foundation

The existence of an LLC begins upon the filing of the articles of organization with the Secretary of State. The articles must be on the form prescribed by the Secretary of State. Among the required information on the form are the latest date at which the LLC is to dissolve and a statement as to whether the LLC will be managed by one manager, more than one manager, or by the members. To validly complete the formation of the LLC, members must enter into an

operation agreement. This operating agreement may come into existence either before or after the filing of the articles of organization and may be either oral or in writing. The articles of organization must specify the date on which the LLC's existence will terminate. Unless otherwise provided in the articles of organization or a written operating agreement, an LLC goes out of business at the death, withdrawal, resignation, expulsion, or bankruptcy of a member (unless the remaining members attain a majority vote within 90 days to continue the LLC).

### Advantages vs. Disadvantages

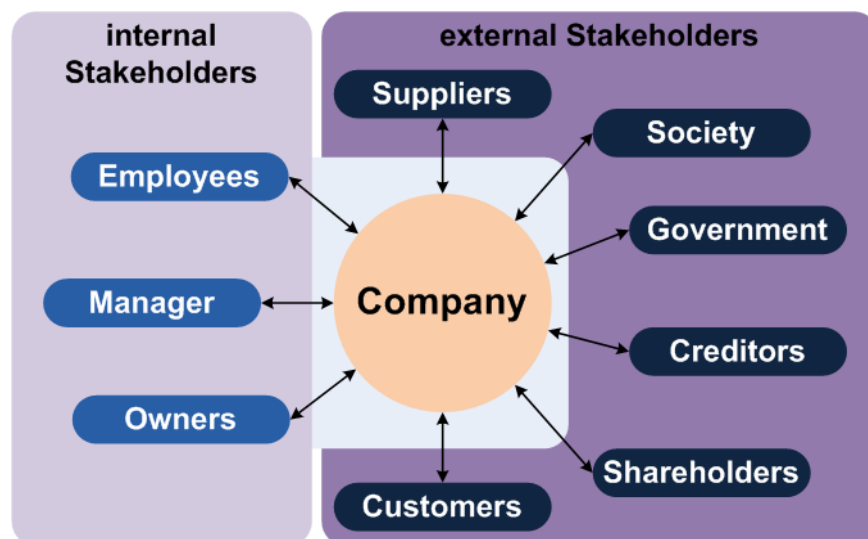
#### Advantages of an LCC

- Its owners, managers, and officers are not personally liable for the company's debts.
- It does not pay taxes.
- It does not require as much paperwork or record keeping as a corporation.

#### Disadvantages of an LCC

- It is not widely accepted since this is a relatively new form of company.
- It is difficult to transact business in states not allowing this form of business.
- Its filing fee is usually much higher than for corporations.

Type of Company	Liability	Operations	Management	Raising Capital
<b>Sole Proprietorship</b>	Unlimited	Simple	Proprietor	Difficult
<b>Partnership</b>	Partners	Simple	Partners	-----
<b>LLC</b>	NO	Medium	Members	Possible
<b>Corporations</b>	NO	Difficult	Board	Stock





## PART VI

### QUESTIONS FOR DISCUSSION:

1. What are the **ADVANTAGES** of **INCORPORATING** a business? **DISADVANTAGES**?
2. How does one become a part owner in a corporation? How **OWNERSHIP** is usually represented?
3. How does common stock usually differ from preferred stock? Which kind would **YOU** prefer to own in a company? Might this differ for different people? Why?
4. Are corporations usually set up or chartered under state laws or under federal laws?
5. Are stocks of all corporations traded on the securities markets? Are the local brokerages firms in your community through which you can buy or sell stocks on these two major stock exchanges? What is meant by “over the counter?”
6. Does the owner of common stock in a corporation usually have any vote in the affairs of the corporation? On what basis, usually?
7. Where would you expect to find the statement as to the duties of the board of directors for any particular corporation?
8. When the investor-owned corporation makes a profit from its operations, to whom does the profit belong? To whom are the profits distributed, and on what basis?
9. Is it necessary for a corporation to make distribution of its profits each year after paying corporation income taxes? Explain.
10. If you were considering a career in a type of business in which there were single-owner firms, partnerships, and also corporations, would your educations and training necessarily be significantly different depending on which kind of business organization you were to consider as a career opportunity? Explain.
11. How do corporations compare in size to partnerships and single owner businesses on the average? How would you measure size for this kind of comparison? Total capital required? Amount of capital invested? Dollar volume of business per year? What would you expect to find usually?

### **IDEAS FOR FURTHER STUDY AND TOPICS FOR TALKS AND DEMONSTRATIONS**

1. Try to determine how many corporations there are in your community? Then call some of them to find out how big they are? How much variation is there in their respective sizes?
2. Have your group discuss starting a corporation. What kind of corporation would you create? What steps would you take to create this corporation?



## Part VII:

# Cooperatives

*“We are stronger as a group than an individual. Think in a cooperative and communal way, set up local food hubs, and create growing communities.”*

—Arthur Potts Dawson

## INTRODUCTION

A cooperative corporation is also a state-chartered business, but it exists to perform specific services for and provide economic benefits to its members rather than to make a profit for investor-owners. Also, it obtains a portion, or all, of its capital funds from the members it serves rather than from outside investors.

Some cooperatives raise a portion of their capital needs by charging a membership fee; others by the sale of shares of stock. Cooperative stock, however, is not traded on the stock exchanges. There is no active market because net operating margins belong to patrons rather than to investors.

The fundamental difference between cooperatives and other types of businesses is in objective. A cooperative seeks to realize economic benefits for its members from services that reduce costs, increase members' income, improve quality, provide an improved service, and develop the best use of members' resources.

Cooperatives thus exist to meet members' needs economically and efficiently. Other types of businesses are motivated by prospective profits on invested capital. Their entire pattern of operations—commodities handled, services performed, operating procedures—is planned and executed with profits as the goal. Actual operations may be similar or comparable, but the motive is different.

The difference in motive is evident in who receives the net margins. In an individually owned business, it is the owner; in a partnership, the partners; in an investor-owned corporation, the stock-holders; in a cooperative, the member-patrons.

Cooperatives (like investor-owned firms) are nearly always incorporated to provide their member-patrons the shelter of limited liability if the business should fail. In relatively rare instances, small cooperatives providing a limited number of services may choose to operate as an unincorporated business. Under these circumstances, the cooperative has a legal status not unlike that of a partnership. There, liability is unlimited, and the death, entry, or

withdrawal of a member makes it necessary to restate, usually in writing, the nature of the relationship between members.

Cooperative corporations have these characteristics:

1. The cooperative corporation operates as an agent. It either buys and sells goods for its members or provides some service for them. Some manufacture and process products. Farmer marketing and purchasing cooperatives act as business agents for farmers. Consumer cooperatives buy for and distribute goods to individual members. Credit unions and organizations, such as group health associations, provide services for members.
2. Capital for cooperative corporations may be provided by the sale of stock that has, by law, a limited return, interest rate, or dividend. In non-stock cooperatives, capital may be obtained from membership fees. Additional capital may be borrowed from members as well as other lenders. The cooperative is responsible for debts to the limit of its assets. Members are responsible only for money each has invested.
3. Cooperatives are managed by officers who are hired by the board of directors. Boards of directors are elected by the cooperative members from their membership. Directors act for members, making policies and employing persons to transact business. Unlike the investor-owned corporation, each person or member of a cooperative usually has only one vote, no matter how many shares of stock the person owns.
4. Policies are decided at the annual meeting of members. Directors are elected at this meeting to make policy decisions between the annual meetings.
5. Cooperatives usually charge enough for goods and services to cover costs. Net margins left over at the close of the business year are returned to members according to the amount of business each did with the cooperative. These returns are often called patronage refunds.



6. The ownership of a member of a cooperative becomes an asset of the member's estate at death. Cooperative operation is not affected.

## DISTINCTIVE PRINCIPLES

Cooperatives have three distinctive principles:

1. Democratic control
2. Limited returns on invested capital
3. Operation on a cost-of-doing business basis

Control of the cooperative rests with the members, who normally exercise their votes, by electing a board of directors at an annual meeting. Most cooperatives allow one vote per member.

Consumer cooperatives usually limit the rate of interest paid on member investment. Returns to members of agricultural cooperatives are more definite. The Capper-Volstead Act gives legal sanction to the right of farmers to formally organize and act together without fear of antitrust action against them for acting together. To qualify for the protection of this act, a cooperative must either limit dividends on stock or membership capital to 8% each year, or restrict voting right to one member, one vote. Each state has its own laws that regulate the formation and operation of cooperatives.

A cooperative normally returns to its members any excess of gross proceeds over expenses. In an investor-oriented firm, this excess is called profits. In the cooperative, it is margin.

This procedure has important federal income tax implications. If excess funds are not retained as profits by the cooperative, they cannot be taxed as corporate income.

Many people form and join cooperative corporations. They form cooperative corporations for stores in urban communities, credit unions, mutual insurance companies, and many other businesses. For example, Associated Press is a cooperative service that gathers news from around the world for member newspapers.

## HOW COOPERATIVES ARE ORGANIZED

Articles of incorporation under which a cooperative functions are normally approved by the Secretary of State in the state in which the cooperative's corporate headquarters are located.

These articles specify the name of the cooperative, its authority, its place of business, the number of directors, and whether the capital is stock or non-stock. In this respect, the cooperative does not differ from the investor-owned corporation.

All corporations must have bylaws, and these tell how the corporation is going to operate. Typically,

these contain provisions for membership eligibility, election of directors, annual meetings, officers' duties, voting rights, dues and assessments, and rate of dividends, if any, to be paid on member capital.

A marketing cooperative may also have a marketing agreement with its members. This agreement may require the member to deliver and market through the cooperative his/her entire marketable production. It might be only a specified commodity produced on a specified block or blocks of land. It might require production in a specified manner.

The relationship between a cooperative and its members often depends on the type of service the cooperative performs. Some associations, particularly marketing associations, require a formal application for membership and issue a membership certificate. Payment of a membership fee, usually refundable on termination of membership, may also be required.

Cooperatives normally fall within three classifications: *local associations*, which serve needs within a fairly confined area; *regional organizations*, which encompass much wider areas; and *federated cooperatives*, which actually are cooperatives of cooperatives.

## COOPERATIVES AS A BUSINESS FIRM

Four groups are involved in the operation of a cooperative: the *member-patrons*, the *directors*, the general manager, and the operating employees.

**Member-patrons.** Member/patrons are the owners, the foundation upon which a cooperative is built. Their voice may be heard on any issue brought before the general membership at the annual membership meeting. In most cooperatives, the one-vote rule is followed for each member regardless of the scope of that member's participation in cooperative services.

**Directors.** Directors are elected by the member/patrons during an annual membership meeting. Directors are charged with establishing policies of operation, and they employ a general manager to oversee the enactment of these policies.

**Manager.** The manager, in turn, employs a staff and serves as the intermediary between employees and the board of directors.

**Employees.** Employees answer to the manager, the manager answers to the directors, and the director answer to the general membership.

## FINANCING

Cooperatives use all the standard methods employed by other business corporations to finance

their operation, plus a few that are unique to cooperatives.

If the association (cooperative) is a capital stock organization, it issues stock certificates as evidence of ownership interest. If the association is a noncapital stock organization, it issues some kind of certificate to show capital contributions of members.

Capital needs are generally obtained from two sources: members who invest in the cooperative to get needed services, and loans that are obtained from lending agencies such as a bank for cooperatives, a commercial bank, or, in certain cases, a government agency.

Funds for day-to-day operation of a cooperative are obtained through day-to-day services provided by the organization. Long-term credit for the construction of buildings and other major needs comes through loans obtained from lending agencies, such as a bank, for cooperatives.

Revolving-capital financing, widely used by cooperatives, is peculiarly suited to cooperative operations. Here is the way it works:

As members do business through a cooperative, they authorize the cooperative to use a portion of the money it has accumulated or saved through their patronage. Or the members may furnish capital based on the dollar value or physical volume of products sold or bought through the cooperative. In either case, this money is identified as a capital investment of the members and is used for capital purposes only.

The money thus collected by the cooperative from patronage is credited to each member on the cooperative's books. At the end of the year, the member is notified or issued some evidence of the total amount he/she has invested in cooperative capital for the year.

The capital accumulated in this manner may be treated as a revolving fund. The funds may be used for repayment of debt, expansion, or for other capital purposes as authorized by the board of directors. As such funds continue to be accumulated; the board authorizes the repayment of funds to those members who contributed in the past.

Repayment goes first to members whose contributions are the oldest in the revolving fund. Normally each year's contributions are issued in a numerical series. Thus, the oldest of the numbered series comes up for repayment first.

As a general rule, the member's evidence of revolving-fund contributions does not have a specified repayment date (due date). Rather, the board establishes revolving fund periods after taking into account the association's financial requirements. Some

cooperatives revolve funds at intervals of five, seven, or 10 years. These time periods are not legal requirements, but they are considered as moral commitments on the part of the cooperative.

The revolving-capital plan allows members to build up equity in their association in proportion to the amount of business they do. It ensures that current investment in the cooperative is largely by the current patrons. It provides an orderly process for returning or withdrawing a member's investment without impairing the total capital structure. And it gives the business flexibility to meet changing conditions that may cause financial needs to change.

Discuss the following statements about the member/user-owned cooperative corporation. Are they advantages or disadvantages?

- Cooperatives are part of the American tradition of private enterprise. People may pool their efforts and funds and solve business problems that would be beyond the ability of any person alone.
- Cooperatives are used by businesses such as farms, newspapers, railroads, florists, pharmacies, hardware stores, as well as by individuals.
- Control of policies is achieved through meetings of members or the directors they elect. Members are encouraged to participate in deciding the future of their cooperative.
- Members benefit from the cooperative according to how much they use it.

## COOPERATIVE SERVICES

There are four basic areas in which agriculture cooperatives operate:

1. Marketing
2. Purchasing
3. Providing services
4. Providing credit

### Marketing Cooperatives

Over the years, American farmers have learned many new techniques for increasing yields and reducing manual labor. At the same time, finding satisfactory markets for their products has become an increasing problem.

Many farmers are more effective in producing than in marketing. Frequently they lack the time or frame of reference to understand and satisfy the demands of today's mass markets. Cooperatives provide them with the marketing tools they need. For one thing, they furnish an increasing variety of off-farm marketing services. In response to the market demand for high-quality and standardized products, they have

pioneered in assembling products from many producers.

By paying producers on the basis of grade and quality, cooperatives encourage farmers to produce the kind and quality of product most in demand.

Cooperatives transport, store, advertise, and promote products for their members. They explore or develop new trade channels—domestic and foreign.

Through research they develop new products or find new uses for what they produce.

Cooperatives have become a valuable bargaining tool for farmers. Compared with producers in other industries, agricultural producers typically lack bargaining power. Why? Because individual farmers produce relatively small volumes and because they lack the bargaining advantage that is associated with product differentiation. (A differentiated product, i.e., a brand-name product, is one with distinctive characteristics that can be emphasized in advertising and that give it special desirability for users who value such characteristics.)

During recent decades, business firms that buy agricultural products have steadily grown in size. For example, many food processors and packers are large corporations with great bargaining strength. Similarly, chain food stores that buy fresh produce and other products in large amounts possess commensurate bargaining power. Cooperatives help farmers match the bargaining strength of other firms.

Marketing cooperatives benefit consumers as well as producers. Because they emphasize grade and quality, they have made producers more quality conscious. Standardized packs of food and food products help consumers shop more efficiently.

### **Purchasing Cooperatives**

Farmers characteristically have sold their output at wholesale prices while paying retail prices for many of their input needs. They gained little advantage from product differentiation; they purchased in relatively small amounts and consequently paid high prices for products with name brands, such as feeds, farm equipment, and petroleum products.

To overcome these problems, farmers turned to the cooperative as an economic tool. In some cases, wholly new cooperatives were organized to manufacture ready-mixed feeds, to purchase, clean, and distribute high-quality seed to members, or to provide other related production services.

Major objectives of purchasing cooperatives are:

- (1) to effect savings for member-patrons through quantity purchasing and manufacturing and efficient distribution methods;

- (2) to procure the type and quality of supplies best adapted to the members' farms and needs; and
- (3) to provide related services that meet the needs of member-patrons.

### **Service Cooperatives**

In discussing cooperatives, we usually pay the most attention to ways in which they contribute to our income. But some cooperatives provide services only indirectly related to the way we make our living. These cooperatives help make our lives a little more comfortable in one way or another. These include health, rural electric, telephone, insurance, irrigation, and grazing co-ops as well as non-farmer credit unions.

### **Credit Cooperatives**

Another important source of loans, which is only available to farmers and fishery operators, is the *Farm Credit System*. Here farmers do not save money, as in credit unions, but they may borrow from local credit cooperatives. The Farm Credit System will be briefly discussed here because of its importance to agriculture.

The Farm Credit System is a nationwide financial cooperative that lends to agriculture and rural America. Congress created the system in 1916 to provide American agriculture with a dependable source of credit.

Today, the system provides more than \$199 billion in loans to more than a half million customers, including farmers, rural homeowners, and agribusinesses. Overall, more than one third of the credit needs of U.S. agriculture are met by system institutions. They also provide other value-added services such as leasing, insurance, and financial consulting.

The Federal Farm Credit Banks Funding Corporation is the fiscal agent for the Farm Credit System Banks. Because System institutions do not accept deposits, they rely on the Funding Corporation to raise money for loans and leases through the sale of Farm Credit System wide debt securities in the U.S. and international money markets. The funds are channeled back to rural America through a nationwide network of more than 200 Farm Credit lending institutions.

More specifically, the Farm Credit System is made up of three Farm Credit Banks: AgFirst, AgriBank, Farm Credit Bank of Texas, and one Agricultural Credit bank, CoBank. These banks provide funds and support services to 203 locally owned Farm Credit associations and numerous cooperatives nationwide.

Typical services offered by the regional Farm Credit banks and associations to eligible borrowers include real estate loans, operating loans, rural home mortgage loans, credit-related life insurance, and various financially related services such as farm record keeping and financial planning. All Farm Credit banks and associations are governed as cooperatives by boards of directors elected by member / borrowers / stockholders.

There is only one bank left with national charters in the Farm Credit System and that is CoBank, which finances agricultural cooperatives, rural utility systems, and other rural businesses throughout the United States. Headquartered in Denver, Colorado, CoBank also provides credit to the Farm Credit associations serving agricultural producers in the New England states, New York, and New Jersey. The last

bank other than CoBank was the bank of St. Paul until it merged with the Farm Credit Bank of St. Louis in 1992 to form AgriBank.

CoBank, which has banking centers across the United States and representative offices in Mexico City and Singapore, also finances U.S. agricultural exports and provides international banking services for the benefit of farmer-owned cooperatives and American agriculture.

The Farm Credit System also has two national service entities, Farm Credit Leasing and the Federal Farm Credit Banks Funding Corporation. Farm Credit Leasing provides equipment-leasing services to eligible agricultural producers, cooperatives, and rural utilities. Headquartered in Minneapolis, Minnesota, it is owned by the system banks and has 11 sales offices nationwide.



## PART VII

### QUESTIONS FOR DISCUSSION:

1. How is a cooperative corporation like an ordinary business corporation? How is it different?
2. How does the purpose of a cooperative cooperation differ from that of an ordinary business corporation? Does this make it a better organization?
3. How is the system of control through voting in a cooperative corporation different from that in an ordinary business corporation? Why?
4. What is the reason that laws governing cooperative corporations prescribe legal limits as to the returns (dividends) that can be paid on invested capital?
5. What is the meaning of nonprofit in a cooperative corporation? Is this not in conflict with what we believe to be some of the advantages of the capitalistic system of business in the United States?
6. Does the government exercise any control over the cooperative corporations?
7. If a group of farmers organizes a cooperative and raises a substantial part of the needed money themselves, what are some of the source from which they may be able to borrow money?
8. Are shares of capital stock in cooperatives, in general, traded as freely as shares of stock in ordinary business corporations?
9. What are three commonly accepted principles of cooperatives?
10. What is the Capper-Volstead Act? How does it affect cooperatives?

### IDEAS FOR FURTHER STUDY AND TOPIC FOR TALKS AND DEMONSTRATIONS

1. Go to your library/ online resources and find what you can about the Roachdale Cooperative in England.
2. Trace the history of the cooperative. What were the first cooperatives? Where were they located?
3. Suppose your group wanted to organize and be responsible for an organization to keep your school classroom clean. What type of organization would you create? Have a group discussion about this?



Part VIII:

# E-Commerce...A New Avenue of Doing Business

*“Guess what? The world changes. eBay has defined e-commerce.”*

*—Meg Whitman*

This section introduces a form of business, e-commerce, which is upwardly trending in today's economy. Highlighting the importance, uses and steps of initiating this type of business to the national and international economy, this section further discusses the amazing opportunities that exist in today's business world as we think about the American Private Enterprise System. This section also shares ways to develop your own business and provide tips to consider when aggressively pursuing opportunities in e-commerce.

To understand the American Private Enterprise System is to understand the impact e-commerce has had on our economy. Today, consumers are very diverse in their needs and wants. They utilize the internet to browse, learn about products, show, and buy a variety of goods and services. Individuals with access to the World Wide Web view it as an avenue of constant information that provides a means to connect to the world at any given time.

E-commerce has been growing at a rapid rate since the inception of the internet. Showing the increase in internet use, in 1997 18.0% of all households had internet use at home. Fifteen years later, 74.8% of all households had internet use at home. In addition, 78.9% of people have a computer at home and 94% utilize the computer to connect to the internet.

Further, in 2012, 45.3% of adults 25 and over were using smartphones that have internet access. Smartphones can be used to send email, browse the web, download apps, maps, social media, listen to music, and play games. The increased use of smartphones and home internet use has made the market readily available for consumers at any given time, highlighting the importance of e-commerce in our economy. By the end of 2013, it is estimated that 150 million (47.3%) of the country's population of 317 million became regular mobile Internet users.

## What is E-Commerce?

There are many different definitions and basics in understanding e-commerce. The definition used in this section explains electronic commerce or e-commerce as a term for any type of business or commercial transaction that involves the transfer of

information across the internet. It covers a range of different types of businesses, from consumer based retail sites through auction or music sites to business exchanges trading goods and services between corporations. In addition, it involves a variety of post and presale activities and it is currently viewed as one of the most important aspects of the Internet to recently emerge.

## Types of E-Commerce

Business News Daily classifies e-commerce into four types that provide an excellent foundation for discussion in this section; business to business (b2b), business to consumer (b2c), consumer to business (c2b), and consumer to consumer (c2c).

- B2B (Business to Business)—in this type of e-commerce, companies normally engage in business with each other. Specifically, manufacturers selling to distributors and wholesalers selling to retailers.
- B2C (Business to Consumer)—this form is the common association of "e-commerce." It encompasses businesses selling to the general public through shopping cart software, without needing any human interaction. An example of this would be Amazon. This form of e-commerce is very popular. In 2012, B2C ecommerce sales grew 21.1% to top \$1 trillion for the first time, according to new global estimates by eMarketer. This year, sales will grow 18.3% to \$1.298 trillion worldwide, eMarketer estimates, as Asia-Pacific surpasses North America to become the world's No. 1 market for B2C e-commerce sales. B2C e-commerce sales in Asia-Pacific grew more than 33% to \$332.46 billion in 2012. This year, the region will see sales increase by more than 30% to over \$433 billion—or more than one-third of all global B2C ecommerce sales.
- C2B (Consumer to Business)—in this scenario, a consumer would post a project with a set budget online, and companies bid on the project. The consumer reviews the bids and selects the company—Eance is an example of this type of e-commerce.
- C2C (Consumer to Consumer)—this type of e-commerce is made up of online classifieds or forums where individuals can buy and sell their goods. A payment system such as PayPal

enables customers to pay in a consumer to consumer type of e-commerce. A specific example of this type of would be eBay or Etsy.

### **Benefits of E-Commerce**

There are many benefits of e-commerce that make it relevant to doing business at a local, national, and international level. For example, it allows consumers to electronically exchange goods and services with no barriers of time or distance. In addition, it has expanded rapidly over the past five years resulting in more businesses transferring sections of their operations onto the internet, potentially cutting operation costs. Below are trends that are favoring e-commerce in comparison to traditional retail (Colao, 2012).

### **Stores Realizing More Profit Online**

Businesses are realizing the opportunities that exist in e-commerce. (Colao, 2012) highlights Macy's, which has seen an online sale increase of 40% in 2011 while same-store sales grew just 5.3%. Further, Nordstrom is offering free shipping and free returns in its online store; the company has notched three straight quarters of 35% gains in online sales focusing on iPod Touches and smartphones. Businesses are seeing increased growth and profit in e-commerce.

### **Cost Efficiency and Receiving the Best Price**

Consumers are noticing that products are often marked up at least three times when purchasing from traditional retail outlets. Specifically, when the product changes hands, the purchase price is usually 2x to 5x the initial price (Colao, 2012). While cutting out the middle man, many online retailers make a profit but also sell at a cheaper price than those that are selling out of physical locations. Ultimately, consumers are realizing that online has more options and cheaper prices.

### **The Benefit of Free**

Consumers want the best prices and prefer to not be penalized when they make a wrong decision. Many businesses are offering returns for free and shipping for free on products that essentially were the wrong decision to consumers in terms of taste, size, or feel. Many consumers initially had doubts of purchasing products online in fear of being the wrong size, color, or style. However, with free shipping and free returns, it makes the decision more acceptable if consumers are allowed to change their mind on their purchase with no additional cost.

### **The Art of Individualism and Personal Satisfaction**

Companies are offering clothing that is accustomed to fit the many types of bodies that resemble the consumer. Consumers have many different body types, styles, and interests in purchasing. Many companies are asking shoppers for their measurements, along with a list of their best fitting clothes to match with the right sizes. Moreover, companies like Accustom Apparel, which uses 3D body scanners along with pattern making software to scale the creation of custom fitted clothing at a digestible price point. Consumers enjoy the personal touch and attention provided their individual needs and wants. The art of making individuals feel unique and catered to is making e-commerce very attractive to consumers.

### **The Self-Appointed Shopper**

Many businesses are making it easier on the consumer by organizing a consistent purchase for the consumer to obtain routine goods and services. Some critics may view this as a lazy shopper, while others say it is a matter of convenience. For example, a purchaser can rely on a routine delivery of household products to show up on the same date every month.

### **E-Commerce here to stay**

Questions may come forth on whether e-commerce is a trend or is it here to stay? However, research supports the claim that e-commerce has a role to play in the long term impact of the United States economy and in it's retail. For example, it is projected that United States retail sales are expected to grow from \$263 billion in 2013 to \$414 billion in 2018, a compound annual growth rate of 9.5%, according to a new online retail sales forecast from Forester Research Inc.

Growth in e-commerce can be contributed to many things. In particular, increased shopping by consumers on mobile phones and tablets leads to the growth. Increased spending by digital natives—consumers who grew up using the Internet from their earliest years—will also contribute to the growth as they move into their prime spending years. In examining generations; Consumers ages 25 and 33 years old (Generation Y) already spend more online than any other age group, an average of \$563 in the last three months. Further, Consumers ages 34 to 47 years old (Generation X), by comparison, spent an average of \$535 online during the last three months. Moreover, the younger generation is more likely to spend a larger share of their retail dollars on the web. Today, 69% of United States adults regularly buy online and purchase about 16% of their products online.

A very important statistic to the future outlook of e-commerce states that by the year 2017, 60% of all United States retail sales will involve the Internet in some way, either as a direct e-commerce transaction or as part of a shopper's research on a laptop or mobile device, according to a new report by Forrester Research Inc. entitled "U.S. Cross-Channel Retail Forecast, 2012 To 2017." Further, approximately 10.3% of total retail sales in the United States in five years will be online purchases, or \$370 billion in web sales compared to \$3.6 trillion in total retail sales.

## The Future

The future of e-commerce is bright and diverse. The categories of goods that will be most influenced by Internet research in five years will be grocery, apparel and accessories, home improvement, and consumer electronics, in particular through mobile activity such as reading customer reviews while in the aisle.

For example, shoppers often buy consumer electronics online, but they more often buy grocery and home improvement items in stores, though they research those products online more frequently than consumer electronics.

Research voices that retailers should focus on three main areas in order to prepare for the web-immersed shoppers of the future. First, retailers should make sure to support self-service mobile functionality for in-store shoppers or provide associates with mobile tools to help shoppers. For example, Wal-Mart Stores Inc.'s mobile app detects when a shopper is in the store and helps her find products or discounts, while Pacific Sunwear of California Inc. gives store associates iPads to help shoppers order online products that are out of stock in stores.

Along with connecting web and store inventories, the third task for retailers to master is to resolve price differences between e-commerce and store catalogs. As more shoppers have smartphones and are able to access prices instantaneously, such discrepancies are likely to work against retailers, particularly if the pricing variances are large and don't favor the customer.

## International E-Commerce

E-commerce has played a huge role not only in the American way of doing business, but also in the International Economy. Although there have been advancements in some countries, several opportunities still exist to capitalize in international e-commerce. Please find examples of a few markets below.

### China:

There are beauty retailers that sell cosmetics and have been slow to adopt an e-commerce strategy that is specific to China. Thirty-two percent of top beauty retailers fail to have a Chinese-language site (including big names such as Calvin Klein, Dior, Gucci, and Chanel). These retailers are missing out on an opportunity to capture more sales in China; 20% of cosmetics sales in the country occur online, compared to just 5% that do in the United States. (L2 Think Tank)

### Nigeria:

Nigeria's e-commerce market has consistently grown 25% and is beginning to have a significant impact on the country's GDP. However, we have found that in most African countries, the growth is only sustainable if more potential consumers gain access to the Internet. African and Middle Eastern regions are among the least developed markets in e-commerce citing huge future opportunities that exist in the area. (Ventures Africa)

In order to excel in international e-commerce, it is important to have flexible pricing, understand exchange rates, and have a sound presentation in pricing, local payments, and taxes.

## Flexible pricing is important.

It is important in e-commerce to branch out and attempt to reach consumers in all different areas. However, the more areas you sell your products, the more market prices to be knowledgeable of. If you sell a product competitively for 1,300 Pesos in the Dominican Republic, converting that product to dollars results in a product that costs about \$32. However, competitors in the United States might price their product at \$50, so even though you are pricing in the local currency, you are not priced competitively and shoppers will abandon your site for a competitors' site.

## Understanding exchange rates is crucial.

Exchange rates allow you to determine how much of one currency you can exchange for another. The dollar's exchange rate tells you how much a dollar is worth in a foreign exchange rate or vice versa. For example, in September 2013, a dollar was worth 1.03 Canadian dollars. So a pair of tennis shoes that cost \$105 American dollars would cost \$108.15 Canadian dollars. Relating to e-commerce, seeing an unfamiliar currency on an e-commerce site is confusing to a lot of people and can lead to the abandonment of online shopping carts. To decrease e-commerce misunderstanding and avoid losing out on potential customers, set prices in local currency.

## **A sound presentation can make a difference.**

Presentation is always important when appealing to consumers. In terms of presentation of pricing, rounding numbers can make a psychological difference to consumers. Exchange rates can cause friendly-looking price figures to turn to less rounded, odd looking numbers. If you show an EU customer a product priced at €23, 81 rather than a more customer-friendly price of €25, 00, you are increasing e-commerce uncertainty and making them aware of the fact that your company is obviously not located in their home country. Customers should see product prices in clean, round numbers to make the shopping experience as quick and efficient as possible.

## **Provide a means for a local payment that is quick and efficient.**

It is important to consider the methods of payment that are consistent with what consumers are utilizing in their local area. Requesting payment from online customers to pay in a way to which they are not accustomed can cut into your revenue. Aim to make the experience of your consumers as easy as possible. You can make them feel at home by working with what they know. In Germany, wire transfers are the most important local payment method and in Japan, the Konbini payment method is a popular alternative, representing nearly 40% of some of clients' Japanese transactions.

## **Showing taxes in a way that is familiar and easily understood.**

Revisiting our previous discussion on presentation, it is important to show sales taxes in way online customers are familiar with to avoid confusion to the consumer. There are also legal points, as some countries have different tax disclosure requirements. In the United States sales tax is added to the marketed price and varies widely across the country and within individual states. In the Europe, value added tax (VAT) is a tax on the perceived value of a product, so it is marketed as a component of the final price.

## **Steps in the Right Direction for Starting an Online Business.**

The choice to start a business can be an important way to sell, market, and advertise your business's goods and services. The following provides an outline to starting an online business: **Starting a Business**

Anytime one chooses to start a business, they are set requirements or guidelines. Before initiating an online business, there are set up steps in starting a business in general. The Small United States Business Administration has put together tools and resources

and which we will aid you from preparing your business plan and to becoming a successful business owner.

### **1. Registering a Domain Name**

A domain name is the web address of your online business. It is important to choose and register a domain name, which is very cost friendly and not very difficult. The avenues to register are Certified Registering Authorities, Internet Domain Name Registration Services and Abusive Domain Name Registration. Be mindful of security risks and scams. The Federal Trade Commission issued a consumer alert about Domain Name Registration scams.

The Internet Corporation for Assigned Names and Numbers has oversight of Internet protocol address space allocation, protocol parameter assignment, domain name system management, and root server system management functions. In addition, it provides updated and current issues on domain names.

### **2. Select a Web Host**

A web host provides support and space for development of your website. As a business, one would want to take into consideration the costs and abilities, such as site maintenance, search registration, and site development. These options vary from host to host.

### **3. Design of a Website**

One of the most important aspects of a website is its design. This is the message, the storefront, and the visible presence that you will be associated with to your consumers. In addition, this is the opportunity to show your creativity and uniqueness that makes your business special. Websites can be designed personally or by hiring someone as your site designer. It is important to follow the same U.S. trademark and intellectual property laws as you would follow in a regular business. Remember that an online business obeys and operates the same way as a regular business despite having an online presence.

### **4. Advertising and Marketing**

An important component of a business is the message sent out to the consumers. Online businesses cannot be successful without customers visiting the site. Visits to the site are the way in which consumers can engage in business with your company. Register with search engines and use keywords that will drive the most traffic to your site. In addition, advertising and marketing online is regulated the same way it is in the real world and some of the same rules may apply. To assist with these regulations there are the advertising and marketing on the internet; rules of the



road and dotcom disclosures, and information about online advertising.

### **5. Comply with Online Business Regulations**

Online businesses must comply with special laws and regulations that apply only to them. These laws may in relation to the different content allowed on the Internet and also on images and potential visitors to the site. To assist with these business regulations, there is the anti-cybersquatting Consumer Protection Act of 1999, selling on the Internet: Prompt Delivery Rules, and Children's Online Privacy Protection Act.

### **6. State and Local Compliance Information**

There are certain federal, state, and city laws that all businesses must following in an online business. It is important to understand and be knowledgeable of these laws.

### **7. Tax Requirements of Federal, State, and local Businesses**

Online businesses must follow the same laws as regular businesses and follow the same federal, state, and local tax laws. In particular, if you are operating your online business in a state that charges a sales tax; or levies a gross receipts or excise tax on businesses, you may have to apply for a tax permit or register with your state revenue agency. In addition, online businesses are responsible for collecting state and

local taxes from their customers and paying these taxes to state and local revenues.

### **8. Understanding International Trade Laws**

Different countries have different laws. It is important to follow international trade laws for online businesses to be sure you are in compliance with all regulations.

### **9. Resources to Consider When Starting a Business**

When starting a business, you want to also think about other avenues of advertising, such as social media, Facebook, Twitter, Instagram. In addition, may want to think about whether or not you want to have additional employees to help in the advertisement, marketing, and design of product and website materials.

This section has provided some very important information currently facing our society and also in terms of a future outlook on how we offer goods and services. How can we branch out our business to the rest of the world with limited resources? How can we make our products global? How can we diversify our industry? All of these are important questions and how we answer them makes a difference in our lives and those in our local, national, and international communities.



## **Part VIII**

### **Questions for Discussion:**

1. What are the benefits and or/disadvantages of e-commerce?
2. Do you feel consumers value online verses traditional retail or is it just a matter of convenience?
3. Do you feel that time of arrival will play a role in the future of e-commerce?
4. Think about your home community; has e-commerce impacted your community in any way?
5. How has social media impacted e-commerce in your opinion?
6. Do you ever view the trend of e-commerce reversing?
7. How does e-commerce influence the three questions in a business of what to produce, how to produce, and for whom to produce?
8. Why do you feel certain industries, such as electronics, are getting more popular in e-commerce versus other industries, such as food?
9. Name an industry that you utilize that specializes in e-commerce?
10. Think about your purchasing decisions. Does e-commerce allow you to purchase a product that you normally would not have access in your home community?
11. What impact does e-commerce have on local jobs?





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