CHAPTER 10

BUSINESS AND INVESTMENT IN A MARKET ECONOMY

1. STARTING A BUSINESS

You Decide To Start a Business

Suppose you want to start a business of your own. You decide to open an art supply shop. You have worked in an art supply store for several years, so you know a lot about art supplies. You are also a good artist. You can sell your own paintings and drawings in your store.

Owning a business yourself would give you a lot of satisfaction. You like to work hard, and you feel sure you can succeed.

You like the idea of being your own boss, making all the decisions about the way to run your business. And since the business will be all yours, the profits will be all yours, also.

- A business owned by one person is called a **sole proprietorship.** The owner is called the **sole proprietor,** or simply the **proprietor.**

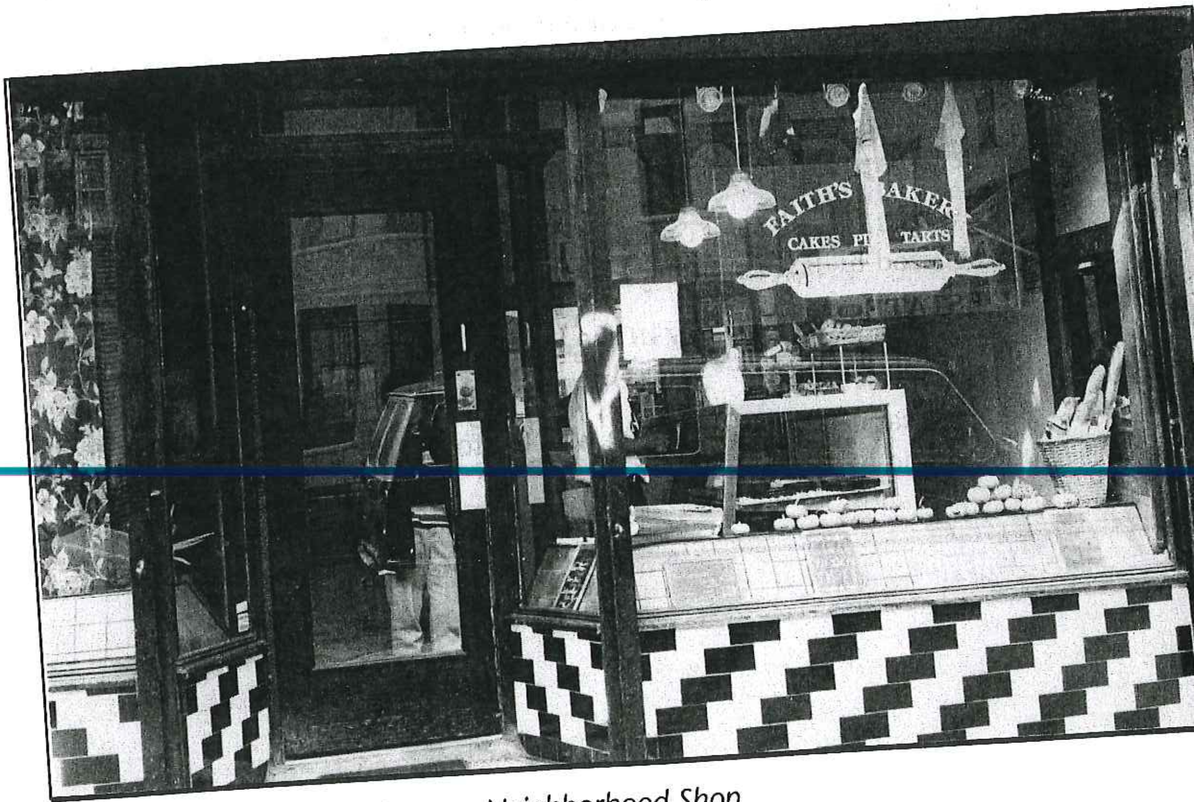

Figure 10–1 A Small Business, a Neighborhood Shop

Figure 10–2 Banks Loan Money to Qualified Borrowers

You make a list of what you will need to get started:

- a shop
- shop fixtures: display shelves, counter, cash register
- inventory—supplies to sell, in this case, art supplies

Since you plan to run the store yourself, you won't need to hire employees.

Finding Investment Capital

Next, you investigate how much money you'll need to rent a shop and fixtures, pay utilities, and buy your inventory.

You figure it will take about three months before you will be earning enough profit to pay your monthly expenses. You will need **investment capital** of $10,000 to get started and run the business for three months.

❖ *Investment Capital = Money used to start a business*

You hadn't expected it to be so much. You've been saving for quite some time, but you only have $5,000.

Loans and Collateral

You decide to get a loan. Your credit rating is good, so surely the bank will agree to loan you $5,000.

"I'm starting an art supply business," you explain to the bank loan officer. "I've saved $5,000, but I need to borrow $5,000 more to get started."

"What **collateral** do you have?" the loan officer asks.

❖ *Collateral = Something of value that a borrower gives a lender as a guarantee that the loan will be repaid*

The only thing you own is your car, but it is old. The bank will loan you only $1,000 on your car.

"This isn't a personal loan," you explain. "It's for my business. I'll be making profits soon. I'm sure I can repay the loan."

"Even for business loans we must have collateral," the loan officer says. "As the sole owner of your business, you are completely **liable** for all the business's debts. A loan to your business is the same as a personal loan as far as the bank is concerned."

> ❖ ***Liable*** *= Legally responsible for something*

Other Ways of Raising Investment Capital

"Perhaps a relative might give you a loan," the loan officer suggests. "Or, you could consider getting a business **partner.**

> ❖ ***Partnership*** *= A business owned by two or more people*
>
> ❖ ***Partner*** *= Each owner in a partnership*

"Maybe you know someone who would be willing to help finance your business in exchange for a share of your profits."

"I don't know anyone who's interested in running an art supply store," you reply. "Besides, I want to run this business in my own way."

"There are different kinds of partnerships," the loan officer explains. "You can arrange your business any way you want.

"In a **general partnership,** each partner helps finance the business and shares in decision making. Each partner also shares the profits of the business and the liability for all its debts.

"However, you could choose to have a **limited partnership.** A limited partner invests money in the business and shares its profits but has little if any decision-making power. The limited partner is not liable for all the debts of the business. If the business fails, the limited partner will lose only the amount of money invested."

Now you have a choice. You can get a personal loan from a friend or relative, or you can find someone willing to invest in your business in exchange for a share of your profits.

2. KINDS OF BUSINESSES

Sole Proprietorships

Seven out of every ten businesses in the United States are sole proprietorships. Almost one-fourth of all business profits are earned by sole proprietorships. However, less than $6 out of every $100 in sales are made by sole proprietorships.

A sole proprietorship is not necessarily run by the owner. In fact, this type of business may have many employees. However, sole proprietorships tend to be small.

Some typical examples of sole proprietorships are—

- Professional offices, such as doctors, dentists, and lawyers
- Services-producing businesses, such as beauticians, laundry and dry cleaning, plumbers, insurance and real-estate brokers, and small construction companies

- Small retail stores, such as grocery stores, florists, and gift shops

The owner of a sole proprietorship has the total responsibility for decision making as well as for the debts of the business. If the business does well, the owner gets all the profits. If the business fails, the owner can lose the business as well as personal possessions to pay off business debts. The failure rate for sole proprietorships is very high.

Partnerships

Only about one in ten of all businesses in the United States are partnerships. Partnerships account for less than $4 out of every $100 in business sales.

Partnerships include many of the same types of businesses as sole proprietorships. Professionals, such as doctors, lawyers, and accountants, frequently form partnerships.

Most partnerships are small businesses that require small amounts of investment capital.

Corporations

Many businesses require larger amounts of investment capital than most sole proprietorships or partnerships have.

In order to get investment capital, a business must have a large number of investors. This is the major reason why businesses **incorporate**, that is, form **corporations.**

- A **corporation** is a business organization that is owned by a group of investors, called its **stockholders.** However, the law treats a corporation as if it were a separate individual.

The biggest businesses in the United States are all corporations.

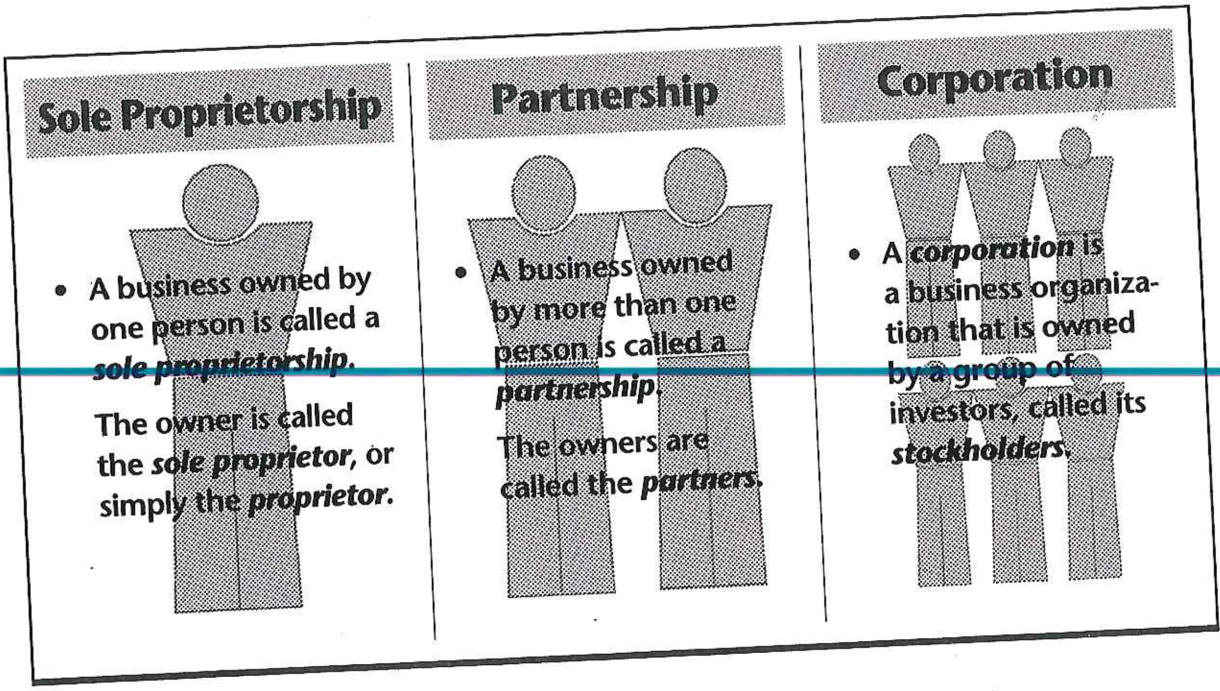

Figure 10–3 Three Types of Business Ownership

3. HOW CORPORATIONS WORK

Incorporating: Beginning a Corporation

A corporation is a much more formal organization than a sole proprietorship or a partnership. People who want to form a corporation must apply for a license, called a **charter**, from their state government. In some states a charter costs a few hundred dollars. In other states, it costs several thousand dollars. The cost of incorporating is one reason many individuals choose to operate their businesses as sole proprietorships or partnerships.

A charter establishes a corporation as a **legal entity**. This means that a corporation is treated as an individual in the eyes of the law.

A corporation can do all of the following things:

- Own property
- Make contracts
- Sell stocks and issue bonds
- Hire workers
- Produce and sell products
- Make a profit
- Pay taxes
- Sue others or be sued in a court of law

A corporation may continue to exist even after its founders die or when its directors or managers change.

About one in every five American businesses is a corporation. However, corporations are responsible for more than $90 out of every $100 in sales in the United States and receive almost three-fourths of all profits.

Who Runs Corporations?

Corporations are run by a **board of directors** chosen by the corporation's owners, or **stockholders**. The board decides—

- What to produce
- How to produce it
- How much to produce
- How to use the corporation's profits
- How much to pay stockholders in dividends

The board also—

- Hires managers and other personnel and appoints a **chief executive officer (CEO)**. In many corporations the CEO is also the company president. In other corporations, the CEO and the president are separate officers.

A corporation's CEO is responsible for carrying out the board's policies and running the corporation on a daily basis.

Figure 10–4 is a general picture of how corporations are organized.

- **Stockholders** provide investment capital for the corporation.
- The **board of directors** makes the basic decisions about how the corporation is to operate.
- **Corporate officers**, including the CEO, are in charge of carrying out the board's policies.
- **Vice presidents** head the major divisions within the company. They report to the company CEO.
- **Department heads** are responsible to the vice presidents.
- Each department head supervises **employees** who do the day-to-day work of the company.

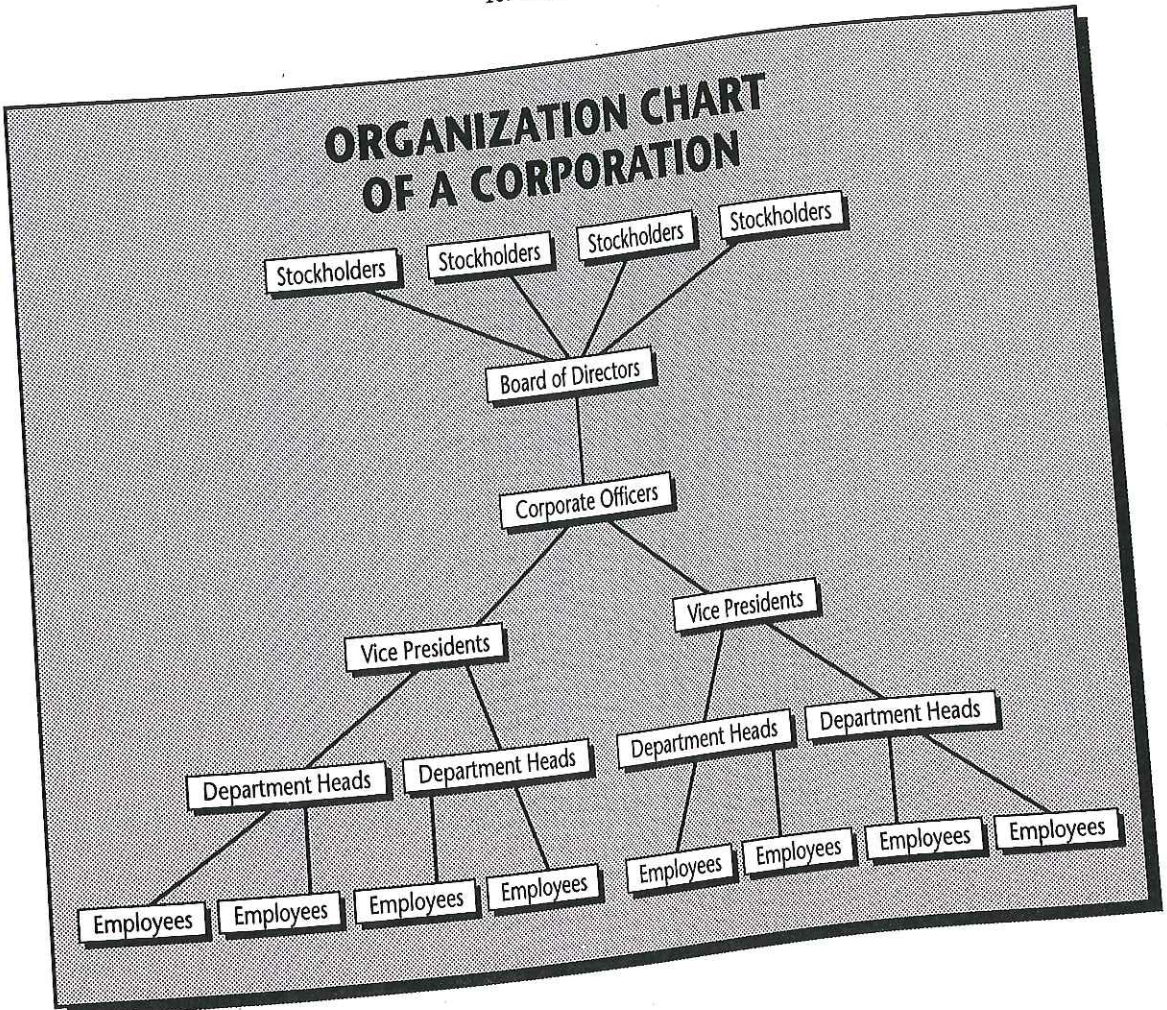

Figure 10–4 *Organization of a Corporation*

Figure 10–5 shows five of the largest corporations in the United States in a recent year and the total sales of each in billions of dollars.

Corporation	Total Sales
General Motors	$125 billion
Exxon	$105 billion
Ford Motor Co.	$98 billion
IBM	$69 billion
General Electric	$58 billion

Figure 10–5 *Corporations with Highest Sales*

Raising Investment Capital for a Corporation

Starting and operating a corporation takes money. This money is called **capital.** Corporations may raise capital from investors by—

- Borrowing money, which the company will then repay to investors with interest. The corporation's promise to repay the loan is called a **bond.**
- Selling shares of ownership in a company. These shares are called **stock.**

Bonds

Corporations can borrow money from investors by selling **bonds.**

> ❖ *Bond = A certificate promising to repay borrowed money with interest*

Investors buy **corporate bonds** (bonds issued by a corporation) in order to make a profit by earning interest on their investment. Buying a corporate bond does not make the investor an owner of the corporation, however. The bond represents a loan to the corporation, not a purchase of a share of ownership.

Stocks

Corporations also raise capital by selling shares of ownership called **stock.**

> ❖ *Stock = Shares of ownership in a corporation*

Investors who buy shares of ownership in a corporation are called **shareholders** or **stockholders**. A corporation is jointly owned by all of its stockholders. Stockholders receive **stock certificates** showing how many shares of the company they own.

Stockholders may sell their shares if they wish. If a corporation goes out of business, the stockholders lose the money they have invested. But they are not personally liable for any of the company's debts.

Stockholders are something like limited partners in a partnership. Even though stockholders own a corporation, they don't have to know anything about running the businesses. They invest to make a profit.

Part of the company's profits are paid to stockholders as **dividends**.

> ❖ *Dividend = a share of a company's profits paid to stockholders*

Also, if a business does well, the value of its stock may go up. Stockholders may then sell their shares for a profit.

Corporations sell two different kinds of stocks:

- Common stock, and
- Preferred stock

Stockholders who hold **common stock—**

- Invest money in the company
- Vote for the board of directors who run the corporation
- In some cases, vote on major policies of the corporation
- May receive dividends, although dividends on common stock are not guaranteed

Stockholders who hold **preferred stock—**

- Invest money in the company, just like holders of common stock
- Usually have no voice in running the corporation
- Are guaranteed to receive dividends from the corporation's profits

Think About It

1. Name the three types of business organizations in a market economy.
2. Which type of business organization is the most common?
3. Which type of business organization is responsible for the largest portion of sales?
4. Give one advantage for incorporating a business. Give one disadvantage of incorporating a business.
5. Name two ways that corporations raise investment capital.

4. INVESTING

Suppose you have some extra money that you don't need for day-to-day expenses. You'd like this money to earn a profit for you. Perhaps it's time to learn about investing.

You have heard that stocks and bonds are sold by brokers. So you go to the office of a brokerage firm that you choose from the list of Stock and Bond Brokers in the Yellow Pages.

"I'd like to learn about buying some stocks," you explain to Ms. Ray, one of the brokers. "I have some extra money, and I'd like it to earn as much as it can."

"Well, the stock market might be a good idea for you," Ms. Ray says. "Let me explain how it works."

Buying and Selling Stocks and Bonds

"As you probably know," Ms. Ray tells you, "companies sell stocks and bonds to raise operating capital. We usually call these stocks and bonds **securities**. Brokerage firms like ours sell these securities to investors like yourself.

"There are thousands of corporations that offer stocks and bonds to investors. Most major corporations list their stocks on one of the stock exchanges.

❖ ***Stock exchange*** *= a place where buyers and sellers meet to buy and sell securities*

"You've probably heard of the New York Stock Exchange. It's the largest stock exchange in the world. It was started in 1792. It's located on Wall Street in New York City. Then there is the American Stock Exchange. The United States also has 10 regional stock exchanges.

"Brokerage firms must be members of a stock exchange in order to sell the securities listed on that exchange. Our firm is a member of the New York Stock Exchange and also the American Stock Exchange.

"Brokers all over the country trade securities for their customers on these stock exchanges. Sometimes we do business by telephone. Big firms such as ours have computer lines directly to the New York Stock Exchange.

"But we also sell securities that are not listed on any stock exchange. Often new companies or small companies sell securities directly through brokers. We call this the over-the-counter market.

"When you buy securities, you get a receipt that shows the value of the bond

Figure 10–6 The New York Stock Exchange

or how many shares of stock you have bought. This receipt is called a **security.** That's how stocks and bonds came to be called securities."

Bonds

"How would securities earn money for me?" you ask.

"Lets start with bonds," says Ms. Ray. "If you buy bonds, you earn a fixed rate of interest every year for the life of the bond. Then when the bond matures, you get your original investment back plus the last interest payment.

If you buy a five year, $1,000 bond, you'll earn interest for five years and have your $1,000 back at the end of that time."

Stocks

"What about stocks?" you ask.

"Stocks earn money in two different ways," explains Ms. Ray. "They pay dividends, and they may be sold at a higher price than you bought them. Let me explain each way to you."

Dividends

"First, corporations pay **dividends** based on their profits. Most corporations pay dividends four times a year. It's called the quarterly dividend. Others pay dividends once or twice a year. If a corporation is not doing well, it might not pay any dividend at all."

Selling Stock

"But the income from dividends is not the main reason people invest in the stock market. The value of your stocks may go up. If you buy stock today for $20 a share and that stock's value goes up to $25 a share by the time you want to sell it, you've made a profit of $5 for every share of stock that you own. This kind of profit is sometimes called a **capital gain.**

"However, stock prices don't always go up. Sometimes they go down. If the value of your stocks is lower when you are ready to sell than it was when you bought those stocks, you'll take a loss.

"Stock prices go up and down depending on how many shares are for sale and how much investors are willing to pay for the shares. If a corporation is stable and earning a profit, many investors may be interested in buying its stock. We call these stocks **blue chip** stocks.

"If investors lose confidence in a corporation, they may decide to sell the shares they own in that corporation. This can drive the stock's price down."

Speculation

"Some investors specialize in taking chances buying stocks at low prices and selling them when the price goes up. This is called **speculation.** But it is impossible to know for sure exactly when a stock price will go up—or even if it will go up at all. So speculators can lose money as well as make money.

"Stocks don't always earn money for the investor. Sometimes investors lose money. That's why you should never put money into stocks unless you can afford to lose that money," Ms. Ray explains.

Choosing Which Stocks or Bonds to Buy

"How do I choose which company's stocks or bonds I might want to buy?" you ask.

"First of all," Ms. Ray answers, "you should choose a corporation that's in good financial shape. For bonds, look for a good interest rate. You also need to think about how long you want to tie your money up. That means that you need to look at the bond's maturity date. Bonds usually come in large units—$1,000, $5,000, or $10,000. If you have a smaller amount to invest, then bonds might not be for you.

"If you're interested in stocks, it depends on whether you want income or long-term growth of your investment. For income, look for a corporation that's been paying good dividends. For growth of your investment, look for a corporation that has a record of growth. You might also choose one whose stock price is low compared to what it has been recently."

Mutual Funds

"You have another option," Ms. Ray continues. "You could invest in a **mutual fund.**

❖ *Mutual fund = a pool of money from investors that is used to buy stocks or bonds*

"A mutual fund is really a special kind of company that buys stock in other companies. It allows many investors to pool their money to invest in a variety of corporations. Some mutual funds invest in bonds; others invest in stocks."

Tax-Free Investments

"If you were in a high income tax bracket, I'd suggest that you might want to consider tax-free investments," Ms. Ray adds. "For example, you don't have to pay income tax on the interest you earn on bonds sold by state and local governments. This kind of bond is called a **municipal bond.** However, the interest rate on municipal bonds is lower than on corporate bonds. So this may or may not be an advantage, depending on what percent of your income you pay in taxes."

The Dow-Jones Industrial Average

"How can I tell how stocks in general are doing?" you ask.

"Have you ever heard of the **Dow Jones Industrial Average?**" Ms. Ray asks you. A lot of people just call it the Dow."

"Yes, I hear how much the Dow goes up or down on the news every night," you tell Ms. Ray. "I always wondered what that meant."

"The Dow is the sum of the closing prices of a selected group of typical stocks. When the Dow goes up, it is a sign that the market is strong. People are buying stocks. Investors have confidence in the market. We call this a **bull market.** When the Dow goes down, it is a sign that fewer people are buying or that stock prices are dropping. We call that a **bear market.**

"How safe are securities?" you ask. "I've heard people talk about stock market crashes and the Great Depression."

"Safety depends on which securities you're talking about," Ms. Ray tells you. "Stock markets crash when investors decide to sell large quantities of stocks, no matter how low the prices go. A crash is the result of loss of confidence in the value of investments. A stock market crash isn't the same thing as a depression. However, the same economic problems that cause a crash can also bring on a depression.

"Government bonds are the safest because they are backed by the government. Some state and local government bonds are also insured. Corporate bonds are safer than stocks. If a corporation fails, it must pay its bondholders before it pays its stockholders.

"Stocks are the biggest risk.

"Well, I'm sure I've told you more than you ever wanted to know about the stock and bond markets," Ms. Ray says. "Here are some data sheets about a few corporations you might be interested in. Give me a call if you decide that buying stocks or bonds is the right investment for you."

Think About It

1. What are *securities*?
2. What is a *stock exchange*?
3. Which stock exchange is the largest in the world?
4. What is meant by *speculation*?
5. What is the difference between *stocks* and *bonds*?
6. Which investments are more risky, stocks or bonds? Why is this true?
7. What is a *mutual fund*?