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Essentials of Economics

FOURTH EDITION

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would requiring companies in developing countries to substantially improve working conditions necessarily increase the well-being of their workers? How might the improved working conditions affect wages? Might workers in low-income countries have a different trade-off between wages and working conditions than workers in affluent countries?

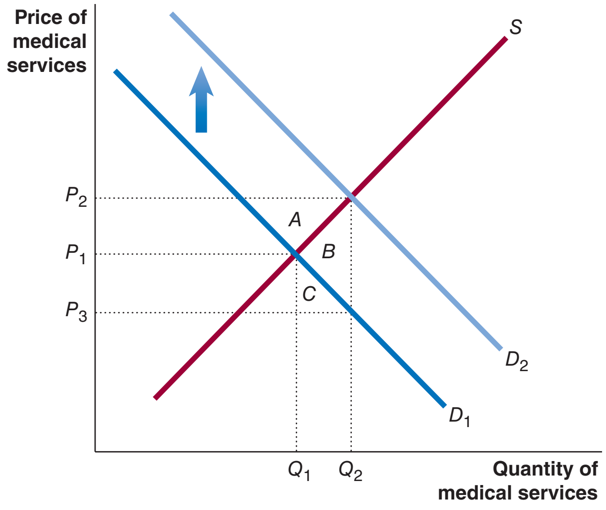
4.13 Suppose consumers pay less than the true cost of medical services because a third party, such as an insurance company or the government, pays most of the bill. In the graph, D_1 represents the demand for medical services if consumers paid the full price of medical services; D_2 represents the demand for medical services when consumers pay only a fraction of the true cost of medical services; and S represents the supply of medical services. Use the graph to answer the following questions. Briefly explain your answers.

a. What is the equilibrium market price received by doctors and other suppliers of medical services?

b. What is the efficient quantity of medical services?

c. What is the price paid by consumers of medical services?

d. Which area represents the deadweight loss resulting from consumers not paying the full price of medical services?



CHAPTER 6

Firms, the Stock Market, and Corporate Governance

Chapter Outline and Learning Objectives

Facebook Learns the Benefits and Costs of Becoming a Publicly Owned Firm

When Mark Zuckerberg started Facebook in 2004, he was a sophomore in college. Just nine years later, Facebook had 1.1 billion active users worldwide. Zuckerberg started Facebook because he believed that people were less interested in meeting new friends online—the assumption built into other social networking sites—than they were in staying in touch with the friends they already had. On Facebook, pages are typically visible only to people the user has linked to, or "friended," which reduces the problem of fake identities that plagued other sites.

By the fall of 2011, Zuckerberg faced a decision: Any business experiencing the runaway success of Facebook needs to raise funds quickly to finance its expansion. Some businesses raise funds by borrowing from banks. Large firms, as Facebook has become, have the ability to sell stocks and bonds to investors in financial markets. Firms that sell stock that is traded in financial markets such as the New York Stock Exchange are called public firms, while firms that do not sell stock are called private firms. For Zuckerberg, turning Facebook into a public firm and selling stock would raise revenue, but buyers of the stock would have partial ownership of the firm and a claim on its profits and might question Zuckerberg's leadership. Zuckerberg would retain control but feared that he might no longer have a completely free hand to continue Facebook's expansion.

Finally, in May 2012, Facebook sold shares of stock to the general public. Many individual investors were eager to buy shares at the initial price of $38 per share. During the following year, though, as more people began using Facebook on smartphones and tablets than on computers, Facebook had difficulty selling advertisements, and its revenue grew more slowly than expected. As a result, Facebook's stock price fluctuated. In 2013, Facebook's stock finally rose above its initial price of $38 per share, providing investors who had bought at that price with significant gains.

As we will see in this chapter, financial markets are an important source of funds to many firms and an important source of investment opportunities to households. More generally, a well-functioning financial system is crucial to the health of the economy.

Sources: Based on Jessi Hempel, "How Facebook Is Taking over Our Lives," *Fortune*, March 11, 2009; Khadeeja Safdar, "Facebook, One Year Later: What Really Happened in the Biggest IPO Flop Ever," *Atlantic*, May 20, 2013; and Evelyn Rusli, "After IPO, Facebook Gets Serious about Making Money," *Wall Street Journal*, May 16, 2013.

Economics in Your Life

Do Corporate Managers Act in the Best Interests of Shareholders?

Although stockholders legally own corporations, managers often have a great deal of freedom in deciding how corporations are run. As a result, managers can make decisions, such as spending money on large corporate headquarters or decorating their offices with expensive paintings, that are in their interests but not in the interests of the shareholders. If managers make decisions that waste money and lower the profits of a firm, the price of the firm's stock will fall, which hurts the investors who own the stock. Suppose you are considering buying stock in a corporation. Why will it be difficult to get the managers to act in your interests rather than in their own? Given this problem, should you ever take on the risk of buying stock? As you read this chapter, try to answer these questions. You can check your answers against those we provide on **page 243** at the end of this chapter.

In this chapter, we look at firms: how they are organized, how they raise funds, and the information they provide to investors. As we have discussed in earlier chapters, firms in a market system are responsible for organizing the factors of production to produce goods and services. Firms are the vehicles entrepreneurs use to earn profits. To succeed, entrepreneurs must meet consumers' wants by producing new or better goods and services or by finding ways to produce existing goods and services at a lower cost so that they can be sold at a lower price. Entrepreneurs also need access to sufficient funds, and they must be able to efficiently organize production. As the typical firm in many industries has become larger over the past 100 years, the task of efficiently organizing production has become more difficult. In the final section of this chapter, we look at problems of *corporate governance* that have occurred in recent years. We also look at the steps firms and the government have taken to avoid similar problems in the future.

6.1 LEARNING OBJECTIVE

Categorize the major types of firms in the United States.

Types of Firms

In studying a market economy, it is important to understand the basics of how firms operate. In the United States, there are three main categories of firms: *sole proprietorships*, *partnerships*, and *corporations*. A **sole proprietorship** is a firm owned by a single individual. Although most sole proprietorships are small, some employ many workers and earn large profits. **Partnerships** are firms owned jointly by two or more—sometimes many—persons. Most law and accounting firms are partnerships. Some of them can be quite large. For instance, in 2013, the Baker & McKenzie law firm based in Chicago had 1,400 partners. Most large firms, though, are organized as *corporations*. A **corporation** is a legal form of business that provides owners with protection from losing more than their investment in the firm should the business fail.

Sole proprietorship A firm owned by a single individual and not organized as a corporation.

Partnership A firm owned jointly by two or more persons and not organized as a corporation.

Corporation A legal form of business that provides owners with protection from losing more than their investment should the business fail.

Who Is Liable? Limited and Unlimited Liability

A key distinction among the three types of firms is that the owners of sole proprietorships and partnerships have unlimited liability, which means that there is no legal distinction between the personal assets of the owners of the firm and the assets of the firm. An **asset** is anything of value owned by a person or a firm. If a sole proprietorship or a partnership owes a lot of money to the firm's suppliers or employees, the suppliers and employees have a legal right to sue the firm for payment, even if in order to pay their debts the firm's owners have to sell some of their personal assets, such as stocks or bonds. In other words, with sole proprietorships and partnerships, the owners are not legally distinct from the firms they own.

Asset Anything of value owned by a person or a firm.

It may only seem fair that the owners of a firm be responsible for the firm's debts. But early in the nineteenth century, it became clear to many state legislatures in the United States that unlimited liability was a significant problem for any firm that was attempting to raise funds from large numbers of investors. An investor might be interested in making a relatively small investment in a firm but be unwilling to become a partner in the firm, for fear of placing at risk all of his or her personal assets if the firm were to fail. To get around this problem, state legislatures began to pass *general incorporation laws*, which allowed firms to be organized as corporations. Under the corporate form of business, the owners of a firm have **limited liability**, which means that if the firm fails, the owners can never lose more than the amount they have invested in the firm. The personal assets of the owners of the firm are not affected by the failure of the firm. In fact, in the eyes of the law, a corporation is a legal "person," separate from its owners. Limited liability has made it possible for corporations to raise funds by issuing shares of stock to large numbers of investors. For example, if you buy a share of Facebook stock, you are a part owner of the firm, but even if Facebook were to go bankrupt, you would

Limited liability The legal provision that shields owners of a corporation from losing more than they have invested in the firm.

Table 6.1

Differences among Business Organizations

	Sole Proprietorship	Partnership	Corporation
Advantages	• Control by owner • No layers of management	• Ability to share work • Ability to share risks	• Limited personal liability • Greater ability to raise funds
Disadvantages	• Unlimited personal liability • Limited ability to raise funds	• Unlimited personal liability • Limited ability to raise funds	• Costly to organize • Possible double taxation of income

not be personally responsible for any of Facebook's debts. Therefore, you could not lose more than the amount you paid for the stock.

Organizing a firm as a corporation also has some disadvantages. In the United States, corporate profits are taxed twice—once at the corporate level and again when investors in the firm receive a share of the firm's profits. Corporations generally are larger than sole proprietorships and partnerships and are therefore more difficult to organize and run. Table 6.1 reviews the advantages and disadvantages of different forms of business organization. MyEconLab Concept Check

Corporations Earn the Majority of Revenue and Profits

Figure 6.1 gives basic statistics on the three types of business organizations. Panel (a) shows that almost three-quarters of all firms are sole proprietorships. Panels (b) and (c) show that although only 18 percent of all firms are corporations, they account for a majority of the revenue and profits earned by all firms. *Profit* is the difference between revenue and the total cost to a firm of producing the goods and services it offers for sale.

There are more than 5.8 million corporations in the United States, but only 35,000 have annual revenues of more than $50 million. We can think of these 35,000 firms—including Apple, McDonald's, and Facebook—as representing "big business." These large firms earn more than 80 percent of the total profits of all corporations in the United States. MyEconLab Concept Check

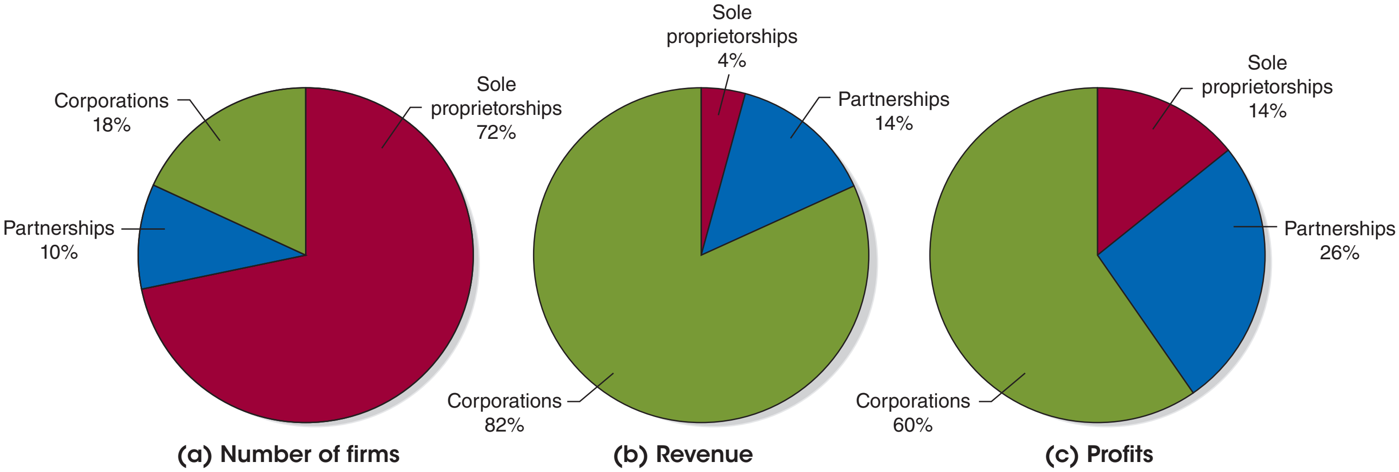


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Figure 6.1 Business Organizations: Sole Proprietorships, Partnerships, and Corporations

The three types of firms in the United States are sole proprietorships, partnerships, and corporations. Panel (a) shows that only 18 percent of all firms are corporations. Yet, as panels (b) and (c) show, corporations account for a majority of the revenue and profits earned by all firms.

Source: Internal Revenue Service, *Statistics on Income*.