

CHAPTER 16

THE BUSINESS SPHERE: FOR-PROFIT FIRMS

Microeconomics in Context (Goodwin, et al.), 2nd Edition

Chapter Summary

This chapter looks at topics including the legal organization of firms, economies of scale and scope, and principal-agent theory. This chapter is an important complement to the material on market power that you studied in Chapter 12.

This chapter aims to provide an understanding of contemporary business issues and corporate power that goes beyond the basic concepts of “imperfect competition.” After studying this chapter you will have a deeper understanding of the goals of firms, the role of transactions costs, and the issue of worker motivation. You will also learn about trends in business mergers and growth, the activities of multinational corporations, the growth of global markets and global competition, and activities such as global subcontracting and offshoring.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Describe the differences between the four legal forms of for-profit enterprises.
2. Comment on the magnitude of the largest firms.
3. Describe the shareholder, stakeholder, and principal-agent theories of business behavior.
4. Describe the conflict and cooperation theories of business management.
5. Discuss the historical development of business firms during the nineteenth and twentieth centuries.
6. Describe some of the reasons firms have increased in magnitude, including economies of scale and scope, integration, and transactions cost economies.
7. Discuss why small firms are likely to continue to coexist besides large, multinational corporations, including the theory of dual sectors.
8. Explain why the information revolution, accompanied by globalization, has been called the “third industrial revolution,” and then list some of the positive and negative aspects of globalization.

Key Term Review

proprietorship
limited liability
cooperative
stakeholder theory
X-inefficiency
economies of scope
vertical integration

partnership
corporation
shareholder theory
principle-agent theory
horizontal integration
transaction cost economies
conglomerates

franchise
globalization
transfer prices
offshoring

dual-sector theory
multinational corporations
subcontracting (outsourcing)

Active Review Questions

Fill in the Blank

1. The main legal forms of private for-profit enterprises are proprietorships, partnerships, corporations, and _____.
2. A business owned by a single individual or family is known as a _____.
3. Corporations are characterized by _____ liability for owners.
4. The larger the enterprise, the greater the benefits of _____ for the owners and investors.
5. A very (large/small) _____ proportion of U.S. businesses have fewer than 20 employees. These small businesses employ a (large/small) _____ proportion of the U.S. labor force.
6. The idea that corporations are merely legal instruments for carrying out the will of their shareholders is known as the _____ theory of the corporation.
7. In the _____ theory of the corporation, the contemporary corporation is seen as a complex social organization with multiple constituencies.
8. A “_____ statute” makes a corporation’s board of directors accountable to groups other than just shareholders.
9. In principal-agent theory, lower-level managers can be described as a(n) _____ to workers.
10. The term _____ refers to a situation in which more labor is used in a production process than is actually necessary.
11. _____ theory focuses on ways of eliciting work through coercion (such as threats of demotion or job loss).
12. Economies of scale arise when larger enterprises operate at a (lower/higher) _____ cost per unit of output.
13. The shifting of production units to foreign locations is known as _____.

14. A legal agreement in which an independent enterprise agrees to abide by standards set by a larger corporation and to compensate it for use of its brand name and other services is known as a _____.

True or False

15. Over half of U.S. employees work for large firms that employ 100 or more workers.

16. The biggest companies in the world--those on the Fortune Global 500 list--are all based in the U.S. or Europe.

17. By definition, and in practice, CEOs, managers, and workers all work in the interest of shareholders.

18. In principal-agent theory, the agent is an economic actor who has an objective that he or she cannot achieve alone.

19. In principal-agent theory, the principal must devise strategies to motivate the agent.

20. A situation in which a company merges with other companies that make similar products can be referred to as horizontal integration.

21. Dual-sector theory describes markets as divided into primary and secondary sectors, where the primary sector consists of perfectly competitive firms while firms in the secondary sector have market power.

Short Answer

22. What is one difference between a corporation and a cooperative?

23. Suggest some ways in which large corporations frequently exercise market power.

24. Explain one possible drawback of attempting to motivate managers through gain-sharing arrangements, such as stock options.

25. Describe two possible ways in which a corporation can respond to a significant increase in international competition.

Self Test

1. Sonya is a partial owner of a business. If the business fails, Sonya's losses cannot exceed the amount of financial capital that she herself has invested in the business. This arrangement is known as

- a. liquid liability
- b. liquidity
- c. a cooperative
- d. limited liability
- e. cooperative liability

2. About what percentage of employers in the U.S. have 100 or more employees?

- a. 2%
- b. 20%
- c. 50%
- d. 65%
- e. 95%

3. In the U.S., about what percentage of employees worked at firms with 100 or more employees?

- a. only a tiny percentage
- b. about a third
- c. over half
- d. nearly all
- e. none

4. The region with the fewest countries in the Fortune Global 500 is
 - a. Western Europe
 - b. East Asia
 - c. South Asia
 - d. Africa
 - e. North America

5. Which of the following is *not* a reason why many businesses have grown over time?
 - a. economies of scale
 - b. breakthroughs in communication technology
 - c. “first mover” advantage
 - d. economies of scope
 - e. consumer desires for unique goods

6. A corporation with market power
 - a. Has zero economic profits.
 - b. Can distribute surplus revenues to shareholders.
 - c. Can use surplus revenues for environmental clean-up.
 - d. Both a and b are true.
 - e. Both b and c are true.

7. The stockholders of a corporation can be considered
 - a. agents to the board
 - b. a principal
 - c. an agent
 - d. a principal-agent combination
 - e. agents to the workers

8. A situation in which more labor is used for production than is actually necessary is known as
 - a. x-efficiency
 - b. x-inefficiency
 - c. labor efficiency
 - d. principal-agent theory
 - e. the conflict model

9. The owner of an oil refinery purchases another, similar oil refinery. This is an example of
 - a. vertical integration

- b. horizontal integration
 - c. a transaction cost
 - d. economy of scope
 - e. none of the above
10. A store that sells ice skates decides to start selling hats and mittens as well. This store is taking advantage of
- a. economies of integration
 - b. vertical integration
 - c. horizontal integration
 - d. economies of scope
 - e. both c and d are true
11. Vertical integration can be a way to achieve
- a. x-efficiency
 - b. horizontal economies
 - c. transaction cost economies
 - d. x-economies
 - e. principal-agent economies
12. A large producer of bread expands by purchasing a flour mill and a large area of land for producing grain. The bread producer now uses its own land to produce flour for the bread it makes. This is an example of
- a. franchise advantage
 - b. first mover advantage
 - c. horizontal integration
 - d. vertical integration
 - e. dual sectors
13. Which of the following is an example of a firm taking advantage of *economies of scope*?
- a. An oil refinery expands to produce more oil.
 - b. An oil refinery purchases an oil extraction firm.
 - c. A hot chocolate shop starts selling cold lemonade in the summer.
 - d. A restaurant expands by opening a new wing.
 - e. An aircraft producer takes over ownership of a small firm that supplies its engines.
14. A company whose subsidiaries carry out unrelated activities is known as a
- a. conglomerate
 - b. vertically integrated firm

- c. franchise
 - d. horizontally integrated firm
 - e. dual sector firm
15. In the situation known as an “oligopoly with a competitive fringe,”
- a. Large companies control all production.
 - b. A small number of small companies control production.
 - c. Each oligopolistic firm makes two main products.
 - d. A few large companies capture the stable core of market demand.
 - e. A few large companies produce for the fluctuating part of the market.
16. Of the 500 CEOs of the largest US companies in 2005, how many were women?
- a. none
 - b. fewer than 10
 - c. about 50
 - d. about 100
 - e. about half
17. A multinational corporation is defined as a corporation that
- a. Outsources production.
 - b. Is not subject to national laws.
 - c. Is always vertically integrated.
 - d. Owns and operates subsidiaries in more than one country.
 - e. All of the above.
18. The prices that subsidiaries within a firm charge to one another are known as
- a. transfer prices
 - b. internal prices
 - c. conglomerate prices
 - d. globalized prices
 - e. subcontract prices
19. A US-based firm decides to move all its clothing production to a country where wages are lower. This is an example of
- a. transfer pricing
 - b. dual sectors
 - c. offshoring
 - d. oligopoly with a competitive fringe
 - e. both a and c are true

20. A business owned by a group of workers, suppliers, or consumers, in which each member has one and only one vote, is known as a

- a. proprietorship
- b. partnership
- c. corporation
- d. cooperative
- e. none of the above

Answers to Active Review Questions

- 1. cooperatives
- 2. proprietorship
- 3. limited
- 4. incorporation
- 5. large; small
- 6. shareholder
- 7. stakeholder
- 8. constituency
- 9. principal
- 10. x-inefficiency
- 11. conflict
- 12. lower
- 13. offshoring
- 14. franchise
- 15. True.
- 16. False.
- 17. False.
- 18. False.
- 19. True.
- 20. True.
- 21. False.
- 22. Corporate ownership generally takes the form of owning stocks. Shareholders govern according to the principle of one share, one vote. Cooperatives, in contrast, cannot issue stock. They are governed according to the principle of one member, one vote. Thus, ownership in a cooperative cannot be accumulated.
- 23. Large corporations often sell their products under oligopolistic conditions. They also buy inputs in markets where they are major players.
- 24. Giving managers interests in the stock value of a firm can create an incentive for them to focus on short-term profitability -- or even just a short-term *appearance* of profitability -- while potentially neglecting the long-term health of the firm.
- 25. One option is for the company to maintain its existing workforce and wage levels, while retraining workers and redesigning products to increase revenues. Another option is for the company to cut costs through measures such as firing workers and reducing wages.

Answers to Self Test Questions

1. d
2. a
3. c
4. d
5. e
6. e
7. b
8. b
9. b
10. d
11. c
12. d
13. c
14. a
15. d
16. b
17. d
18. a
19. c
20. d