IB Business Management Assignment 2 – 16th July 2021

Read the enclosed text and then create a revision diagram. The diagram has to be clear and well presented and contain all key points. Email the diagram to mbogan@knoleacademy.org for July 16th.

Distinction between the private and public sectors

One of the first things to understand when learning about an organisation is: who does it belong to? As you can imagine, a hospital owned by the government may have different priorities than one owned and run by a private company intending to earn a profit. There are actually three sectors in the economy: the public, the private, and the non-profit sectors. We will begin by discussing the private and public sectors.

The **private sector** includes all organisations owned by individuals or groups of individuals. Most organisations that we think of as 'businesses' are part of the private sector. Businesses in the private sector need to earn profits in order to compensate the owners for their investment in the business. As we learned in Subtopic 1.1, entrepreneurs work hard in order to set up their businesses; most expect to earn profits as compensation for their hard work and the personal funds they put into the business. Larger enterprises may be owned by more than one individual, but their owners also expect to earn a return on funds they invest in the business. If you are not sure about exactly what profits are, they will be described in more detail in Subtopics 3.4 and 3.7.

Organisations in the **public sector** do not function under the same profit-making imperative. These organisations are generally created by governments in order to provide public goods. National governments provide protection to their citizens; to do so they run military organisations like the army and navy, and sometimes national police services. Central governments are often responsible for transportation infrastructure, including roads, railways, and airports. In many countries they are the unique providers of higher education, so they own and run universities. Other institutions run by national governments may include museums, hospitals, and mail delivery services, not to mention embassies, consulates, immigration services and customs offices. National governments may also have a role in running schools.

Local governments also provide public services; they often own and run schools, hospitals, police and fire departments, as well as organisations that take care of municipal services like providing drinking water, treating wastewater, and disposing of garbage. At best, these government-owned organisations break even; that is, their revenues cover their expenses. In most cases, however, governments subsidise these institutions from tax revenues. They do so because the services provided are necessary for society to function.

To summarise, organisations in the public sector usually have the provision of public services as their primary objective, whereas organisations in the private sector are more fundamentally driven by the need to earn profits.

Definition

The **public sector** includes all those organisations that are owned and operated by either the central government or local governments (municipalities), or their agencies, such as the National Health Service in the United Kingdom. Institutions in the public sector are usually dedicated to providing services to the public rather than earning a profit.

The **private sector** includes all those organisations that are owned by individuals or groups of individuals. Organisations in the private sector are usually constrained by the necessity of earning profits in order to compensate their owners for the investment they have made in the organisation.

Types of organisations

In the remainder of this subtopic, we will focus on the types of organisations operating in the private and non-profit sectors. (We will not further discuss organisations operating in the public sector). A summary of these private and non-profit organisations included in the IB syllabus is shown below. Notice that in addition to organisations that operate in one of the two sectors, there are other terms included in this subtopic. As we will see, these organisations and partnerships involve institutions that do not fit neatly into either the category 'for profit' or 'non-profit'.

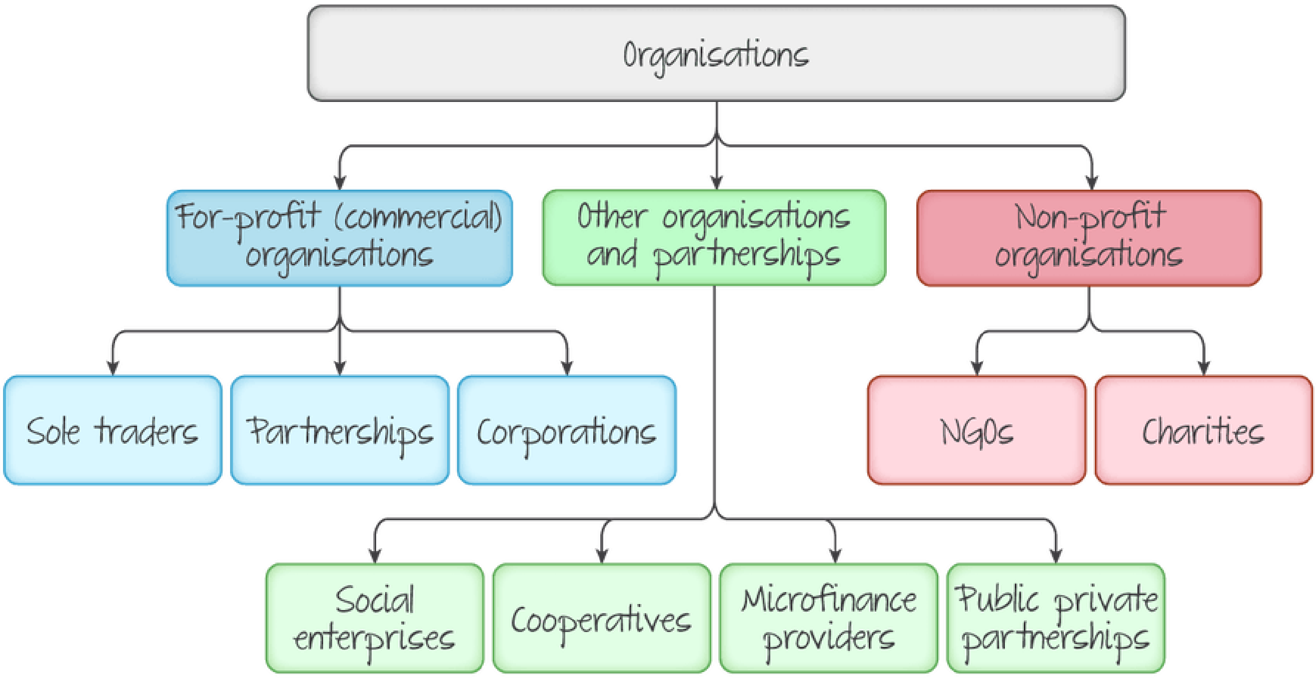

Figure 1. An overview of the different types of organisations included in the syllabus.

The main features of the different types of for-profit (commercial) organisations

Organisations operating in the private sector can be grouped into three main categories:

- Sole traders
- Partnerships
- Companies/corporations

As a general rule, sole traders are small organisations, while partnerships are larger and corporations are larger still. Some organisations are created as sole traders or partnerships and retain this status for as long as they remain in business. Other organisations may change their ownership form as they grow and develop. That is, both sole traders and partnerships may eventually become corporations.

Sole traders are individuals who own and run their businesses alone. There is little legal distinction between the individual and their business, and this form of organisation is therefore relatively easy to set up. Another advantage of this form of ownership is that sole traders are able to run the business as they deem fit and keep all the profits. They can choose whether to reinvest profits in the business, or use them to meet their own financial needs.

On the other hand, sole traders are also personally responsible for any losses the business might incur. That is, if the business is unable to pay its debts, creditors (such as suppliers and banks, for example) can seize the owner's personal possessions, including their home. Sole traders may hire employees to help them, but these employees have no ownership interest in the business. Another potential disadvantage of businesses operating as sole traders is the lack of distinction between the owner and the business. If the owner dies or becomes incapacitated, for example, the future of the business itself may be uncertain. The owner's family and heirs may dispute for control, unless clear legal provisions have been made beforehand.

Partnerships involve the creation of a business by two or more individuals called partners. Partnerships are governed by partnership agreements, which define the ownership interests of the different partners, as well as how major decisions will be made by the partnership. Two partners may set up a business where ownership and control are split 50/50 between the partners, or they may determine another arrangement that suits the purposes of the business. For example, there may be a 'silent' or 'sleeping' partner, who contributes funds and benefits from some portion of profits, but who does not participate in the running of the business. Or ownership can be split in an unequal manner, based on the expected contributions of each partner. The partnership agreement, or deed of partnership, also usually stipulates how the partnership will manage the withdrawal or death of one or more of the partners. In the event that provisions for these events are not made, the partnership will have to be dissolved and recreated in the event of the withdrawal or death of a partner.

Most partnerships share a main disadvantage with sole traders, in that all partners’ personal assets may be seized to pay for the debts of the business. This **unlimited liability** for losses is potentially even more damaging in the case of partnerships, because each partner may have limited control over the actions of the others. In the event of bankruptcy, creditors may go after the partner with the 'deepest pockets'; that is, the one who has the most personal assets. Bottom line: be careful before entering into a partnership! (In some countries partnerships can be set up that do not expose all partners to unlimited liability.)

Corporations are the sort of organisation many of us think of when we think of business. Corporations are generally large organisations owned by many individuals and groups of individuals, known as shareholders. The term shareholders can be taken literally, as these individuals each own a share of the business. The possession of a single share gives the shareholder the right:

1. To vote at the Annual General Meeting, where decisions may be made regarding the management of the company, and
2. To receive a portion of the company’s profits in the form of dividends if these are paid (not all companies pay dividends every year).

When businesses are incorporated, they become legal entities separate from their shareholders. These shareholders enjoy **limited liability**. This means that if the corporation performs badly and incurs losses, its owners cannot lose more than the funds that they invested in the business. There is a complete separation between shareholders’ personal assets and their ownership interest in the business. Even if the company goes bankrupt, creditors can only seize the assets of the corporation itself, not the personal possessions of its owners.

Limited liability is a powerful tool that allows corporations to access financing more easily than sole traders and partnerships. Investors can buy shares of the company in the hope of making a good return without exposing themselves to undue risk. A business organised as a corporation also has a legal identity as a 'person' that is completely independent of its owners. Thus the death of a shareholder has no impact upon the continued functioning of the corporation. Shareholders are, in most cases, also free to sell their shares in the corporation, and this sale will generally have a limited impact on the corporation.

Private limited companies are owned by a relatively small number of shareholders, who may find it difficult to sell their shares if they wish to 'cash out' and use the funds for another purpose. Many private limited companies are owned by families, such as the Elsener family, who own Victorinox, the maker of Swiss army knives.

Private limited companies who wish to access large amounts of capital in order to grow may decide to 'go public' in an Initial Public Offering (IPO). An IPO refers to the sale of a company's shares to the public for the first time. The IPO results in the company becoming a **public limited company.** Public limited companies therefore have greater access to capital than do private companies. However, in exchange, they must publish their financial accounts, making this information available to the public, including potential competitors. Another disadvantage of going public is that public limited companies can be 'taken over' by other companies, sometimes because they have been poorly managed. We will learn about takeovers in section 1.6.3.

Definition

A **sole trader** is a for-profit business owned by a single individual. There is little legal distinction between the business and its owner and the owner is personally responsible for the debts of the business.

A **partnership** is a for-profit business owned by two or more individuals who are each personally responsible for the debts of the business. Most partnerships are set up under a partnership agreement that determines how major decisions are to be made, as well as the impact on the partnership of the decease or withdrawal of one of the partners.

A **corporation** is a for-profit business owned by numerous shareholders who enjoy limited liability. That is, individual shareholders are not responsible for the debts of the business.

Table 1. Businesses in the private sector.

Advantages	Disadvantages
Sole trader	
Easy to set up	Unlimited liability
Owner has total control	No help with decision-making
Owner keeps all profits	Owner assumes all losses
Financial performance remains confidential	Limited access to financing
	Uncertainty should the owner die or become incapacitated
Partnership	
Financial performance remains confidential	Unlimited liability
Partners share management responsibility	Partners share profits

Table 1. Businesses in the private sector.

Advantages	Disadvantages
Partners may have complementary expertise	Partners may disagree
Partners may each contribute financing	Potential sources of additional financing remain limited compared to corporations
Corporations	
Limited liability	Administratively difficult and expensive to create
Independent legal identity	Potential for conflicts of interest between owners and managers; management may not always act in shareholders' interests
Can raise large amounts of funds by selling shares	Financial accounts must be published every quarter in the case of public limited companies
Death or change in ownership does not have an impact on the corporation	Selling shares dilutes the ownership of the corporation and control cannot be exerted over who buys the shares in the case of a public limited company

Non-profit organisations

Just like businesses, non-profit organisations come in all shapes and sizes. What they share is a commitment to a purpose other than profit-making. Most non-profit organisations are created to carry out a particular purpose or mission. Once created, non-profits have no owners; they essentially own themselves. This arrangement can be a great source of strength for the organisation. Getting back to our university example from The big picture in topic 1, you might remember that some of the most prestigious American universities are organised as non-profits. Because they have no owners, these institutions are primarily accountable to themselves and their educational aims. They can charge tuition fees, accept research grants, and solicit donations from their alumni. All these funds are used to run the institution and invest for the future. Any 'surplus' left after paying expenses is reinvested in the institution. In the case of universities, the cumulated surplus is known as an endowment. Interest earned on these endowments often contributes in a significant way to the costs of running the institution.

Most non-profits are run by a Board of Directors who are responsible for hiring senior staff that carry out the organisation’s purported mission. The Board is also accountable to third parties, such as the community where they operate. Most non-profits do not pay taxes; to benefit from this exemption they must demonstrate to tax authorities that they are indeed improving society through their work. Specific requirements vary in different countries.

Non-profits are generally categorised based on their primary purpose. In addition to universities, many schools, hospitals and cultural institutions are organised as non-profits. Religious organisations are also generally run as non-profits. Political parties, labour unions, and professional organisations are also usually set up as non-profit organisations. Other non-profits are created to help the disadvantaged or to defend the environment.

Non-profit pressure groups aim to change public policy or public opinion. Mothers Against Drunk Driving is an example in the United States. Non-profit foundations are usually created by wealthy individuals who provide grants to other organisations or individuals who are working to improve society. The Bill and Melinda Gates Foundation is the biggest current example of a foundation.

The IB syllabus refers to two types of non-profit organisations: non-governmental organisations (NGOs) and charities.

Non-governmental organisations (NGOs)

Non-governmental organisations might be defined as a broad category of non-profit organisations that have a purpose or mission to benefit society or the environment. According to NGO expert Pete Willets, the term was first used by the United Nations in 1945, when they defined NGOs as organisations that met the following criteria:

- Non-profit organisation
- Not controlled by a government
- Not a political party
- Not narrowly focused on human rights
- Not involved in criminal activities

The term NGO began to be used more widely in the 1970s. There is no legal definition of NGO, but the criteria above are still generally applicable to organisations describing themselves as NGOs. However, the last two criteria may not always be met. Greenpeace is considered as a NGO, although it does occasionally get into trouble with the law in order to advocate for environmental protection. Amnesty International is also called a NGO, even though its primary purpose is to defend human rights. An enormous range of organisations are described as NGOs. Commonly known examples include Save the Children, Doctors without Borders, and organisations associated with the Red Cross and the Red Crescent movements.

Definition

Non-governmental organisations (NGOs) are non-profit organisations that usually state their purpose or mission as benefiting society or the environment.

Charities

The term **charity** is an older term than NGO, but the two terms are often used to refer to the same organisations. Like NGO, the word charity can be used to describe many different types of non-profit organisations. 'Charity' has a legal definition in the UK because status as a charity provides an organisation with certain tax advantages. Under UK law, an organisation can be established as a charity if it exists 'for charitable purposes only' and will act in the 'public benefit'. The UK Charity Commission’s guidelines published in 2013 provide for a wide variety of activities that can be carried out by charities in that country. They include:

- The prevention and relief of poverty;
- The advancement of education, religion, or health;
- The advancement of citizenship and community development;
- The advancement of the arts, culture, heritage, science and sport;

- The advancement of human rights, conflict resolution, and social harmony between diverse groups;
- The advancement of animal welfare and environmental protection;
- Help to those in need due to their age, health, disability, or financial circumstances;
- Support of the military, police, fire, ambulance and rescue services;
- Any other charitable purpose.

Definition

Charities are non-profit organisations that exist to benefit the public. Charities enjoy tax advantages under UK law.

Other types of organisations and partnerships

The following terms describe organisations and partnerships that do not fit neatly into either the private sector or the non-profit sector.

- Cooperatives
- Microfinance providers
- Public-private partnerships
- Social enterprises

Cooperatives

Cooperatives are organisations that are owned by their members. These members have come together to create and run the organisation in their common interest. An important element of the cooperative form of organisation is their democratic governance. In some way, all members participate in decision-making either through direct democracy (voting on important decisions) or through representation (members vote to elect representatives who make decisions on behalf of all members).

Some of the most common cooperatives are **agricultural cooperatives**. These farmers' co-ops, as they are often called, are created for a variety of reasons. Some exist to negotiate lower prices on inputs like fertiliser and seeds, others are involved in negotiating better prices for the farm products produced, and still others are principally involved in pooling assets to purchase expensive equipment.

A common type of agricultural cooperative is the dairy cooperative. Dairy products, like milk, are a commodity, because most milk (except perhaps organic milk) is the same. (Fat percentages like whole milk and skim milk are created by processing, not by the raw milk itself). For this reason, large wholesalers and supermarket chains can be in a powerful position when negotiating the purchase of milk from farmers. In response to this pressure on prices, farmers can group together in a cooperative to better negotiate prices. Many dairy cooperatives also own their own milk processing plants and transportation equipment.

Some agricultural cooperatives even develop their own credit unions, operating like banks, and permitting farmers to pay lower interest rates on loans. One such credit union, the Credit Agricole in France, grew into a multipurpose bank, but has retained elements of its ownership status as a cooperative. As of 2016, it was considered the largest cooperative in the world, as shown in the table below.

Retail cooperatives involve individual shopkeepers who form cooperatives to better negotiate with the suppliers of the products sold in their stores. Shops may also share the same brand identity, making it possible for them to pool their resources on marketing as well. According to the International Cooperative Alliance, the largest retail cooperative in the world is the REWE Group from Germany, with thousands of member retail outlets and travel agencies located throughout Europe operating under many different brand names.

Consumer cooperatives are set up by consumers in order to benefit from lower prices, better service, or both. Consumer food cooperatives involve setting up a retail shop. In some consumer cooperatives, members work in the shop in exchange for the right to enjoy the low prices that come with membership. Consumer cooperatives in the insurance industry often include 'mutual' in their name, as members mutualise or pool together their risk. Credit unions are consumer cooperatives that provide banking services. As shown in **Table 1**, many of the largest cooperatives worldwide are in the banking industry.

Workers' cooperatives involve groups of workers who collectively own the business where they work. Often worker cooperatives are set up because the previous owner plans to sell or shut down the enterprise. Setting up the worker cooperative thereby preserves the workers' jobs. Because workers find themselves as owners and not mere employees, their increased commitment to the enterprise can, in some cases, result in better management, allowing the survival of a business that might otherwise not been competitive.

In the housing industry, **residents' cooperatives** own and maintain the public spaces of residential properties, such as hallways, stairways, elevators and the façade of the building, as well as shared green spaces and drives on the exterior of the property.

Definition

A **cooperative** is an organisation that is owned by its members who come together to work towards a common interest. Cooperatives are run democratically, with members having a say in important decisions.

Microfinance providers

Microfinance is the activity of providing financial services to individuals with very limited means, who would otherwise be ignored by traditional banks. Financial services can include the provision of checking and savings accounts as well as insurance products. One of the most publicised activities of microfinance providers has been the granting of very small loans to individuals in order to get them started in business. Lending very small amounts is called **microcredit.** According to Visionfund International, the average size of microcredit loans as of August 2016 was $503 worldwide. Average loan sizes varied from an average of $260 in Africa to an average of $1585 in the grouping comprised of countries in Eastern Europe and the Middle East.

Microcredit loans are frequently granted for shorter durations than typical commercial loans, often from only six months to one year. Some microfinance providers have been criticised for charging high interest rates on microcredit loans. They have responded by explaining that the cost of administering these small loans is expensive, in part because payments may be collected on a monthly or even a weekly basis in order to ensure that individuals starting small businesses do not become overwhelmed with larger, less frequent payments. Many microfinance providers also provide business support services for their clients, who are often located in rural areas. These aspects of microfinance also increase the costs of the business model compared to more typical financial institutions who often lend large sums to large established businesses located in urban areas.

Microfinance providers can take many different forms of ownership, including non-profit institutions, for-profit corporations and cooperatives. According to the World Bank, non-profit institutions involved in microfinance tend to help the poorest segment of the population and grant the smallest loans. For-profit banks involved in microfinance tend to grant bigger loans to relatively better-off borrowers. Click here to investigate Al Majmoua, an example of a non-profit microfinance provider operating in Lebanon.

The largest microfinance provider in the world is the Grameen Bank, which is organised as a cooperative. Click here to listen to Muhammad Yunus, the founder of Grameen Bank, who is also credited with creating the modern microfinance industry. He begins by talking about Grameen Bank and goes on to discuss other social enterprises with which he has been involved.

Definition

Microfinance providers make financial services available to individuals whose needs would otherwise not be met by traditional financial institutions like banks.

Public-private partnerships (PPPs)

The term **Public-private partnership** refers to an enormous variety of arrangements whereby the government works with either the private sector or the non-profit sector (and sometimes both) in order to accomplish its goals more efficiently and effectively. PPPs can involve either the delivery of services or the development of infrastructure. They are usually long-term arrangements and can involve almost any aspect of public sector activities, including education, health care and construction projects. An important aspect of PPPs is that the public sector and the private sector partner share both risk and reward.

PPPs first came to be commonly used in the 1990s to build infrastructure projects like roads, bridges, and water and sanitation facilities. To a lesser extent, they have also been used to build and operate hospitals, schools, and even prisons. The model frequently used is called BOT, for Build, Operate, Transfer. Under these types of arrangements, the public sector contracts with a private sector company under a long-term agreement. The private company builds the facility and operates it until ownership is eventually turned back to the public sector after about 10 to 20 years.

In the case of infrastructure projects more particularly, PPPs often involve the private sector partner financing the project. That is, they are not paid upfront for building a bridge or a road, for example, but are rather paid over the useful life of the infrastructure. Either the private partner can either collect user fees directly (tolls), or the government can pay the private partner under the condition that the infrastructure is useful and well maintained. Usually there is a defined end to the PPP arrangement, when ownership of the infrastructure built reverts to the public sector. Sharing risk and reward in the case of an infrastructure project means that if, for example, the private sector partner is able to build the facility at a lower cost than expected, it will earn more profits. If, on the other hand, the project runs over budget, the private sector partner may lose money.

The benefits of PPPs for government include the following:

- Because the private partner may provide project financing, PPPs can permit the completion of projects that the government might have been unable to finance on its own.

- Governments may benefit from the expertise of private enterprise.
- Because the private partner shares in the risk and reward of the project, they are incentivised to innovate in order to save costs.

Limitations of PPPs include the following:

- Setting up and monitoring a PPP can be expensive; PPPs may therefore not be suitable for smaller projects.
- Because PPPs require that contracts be signed for a long duration, they may not be appropriate in certain sectors, such as IT, where conditions change rapidly. If the cost of IT services declines rapidly, for example, the public sector could end up overpaying for services if the PPP contract cannot be renegotiated.

The types of arrangements that are considered PPPs vary from one country to the next. In some countries, to be considered a PPP, the private party must bear a significant portion of the risk of the project. In other countries, this is not the case.

More recently, PPPs have involved and even been initiated by non-governmental organisations (NGOs). These partnerships often involve NGOs, governments, and pharmaceutical companies working together to improve public health. According to the Bill and Melinda Gates Foundation, as of 2016 there were around 10 PPPs working to develop vaccines or drugs for diseases that cause the greatest harm in developing countries, such as AIDS, malaria, and parasitic diseases.

Definition

Public-private partnerships (PPPs) are arrangements whereby the public sector enlists the help of a private sector organisation in order to meet its objectives more efficiently. PPPs often involve large infrastructure projects.

Social enterprises

The term **social enterprise** is only about two decades old and does not have a formal definition; the term does not provide information as to the nature of ownership of an organisation. The description 'social enterprise' is used in a variety of ways by different groups. In general, there are two categories of social enterprises: for-profit and non-profit.

All three types of for-profit organisations (sole traders, partnerships, and corporations) can consider themselves social enterprises. They usually do so for one of three reasons:

1. The business sells products or services that benefit not just the customer, but society as a whole. An example is Frogtec, a company that provides phone applications to help small shopkeepers in Latin America to better manage their businesses. These small business owners can in turn offer more affordable food prices to their communities.
2. The business's products may be something more banal, like coffee; however, the coffee may be sourced sustainably, and/or a portion of the profits may be set aside to support a worthy cause.

3. In still other cases, the social enterprise resembles an ordinary business, but is staffed by employees who might have had a difficult time finding employment in a more typical working environment.

Non-profits that call themselves social enterprises usually do so because they earn a significant portion of their revenues through trading, rather than relying exclusively on donations and grants from the government or from foundations.

Some cooperatives and microfinance providers may also consider themselves social enterprises. Social Enterprise UK represents the interests of social enterprises in the UK, where they report that there are over 70,000 such organisations.

Definition

Social enterprises are organisations that engage in business activity but that have also set themselves important goals in terms of improving society or protecting the environment. Social enterprises may be organised as for-profit businesses, non-profit organisations, or cooperatives.