We begin this appendix by defining two broad categories of risk: pure risk and speculative risk. We then examine several methods of risk management available to individuals and businesses and consider situations in which each method is appropriate. Next, we turn our attention to insurance companies—organizations that, for a fee, assume financial responsibility for losses resulting from certain kinds of risks. We see how insurance companies determine which risks they will cover and what prices they will charge for coverage. Then we list the major types of insurance against loss of property and loss due to accidents and discuss workers’ compensation and health care insurance. We close the appendix with a comparison of several kinds of life insurance.

The Element of Risk

Risk is the possibility that a loss or injury will occur. It is impossible to escape all types of risk in today’s world. For individuals, driving an automobile, investing in stocks or bonds, and even jogging along a country road are situations that involve some risk. For businesses, risk is a part of every decision. In fact, the essence of business decision making is weighing the potential risks and gains involved in various courses of action.

There is obviously a difference between, say, the risk of losing money one has invested and the risk of being hit by a car while jogging. This difference leads to the classification of risks as either speculative or pure risks.

A speculative risk is a risk that accompanies the possibility of earning a profit. Most business decisions, such as the decision to market a new product, involve speculative risks. If the new product succeeds in the marketplace, there are profits; if it fails, there are losses. For example, PepsiCo repeatedly gambles on the introduction of new products to compete with Coca-Cola and reach the elusive top spot. But the gamble does not pay off when the product fizzles.

A pure risk is a risk that involves only the possibility of loss, with no potential for gain. The possibility of damage due to hurricane, fire, or automobile accident is a pure risk because there is no gain if such damage does not occur. Another pure risk is the risk of large medical bills resulting from a serious illness. Again, if there is no illness, there is no monetary gain.

Let us now look at the various techniques available for managing risk.

Risk Management

Risk management is the process of evaluating the risks faced by a firm or an individual and then minimizing the costs involved with those risks. Any risk entails two types of costs. The first is the cost that will be incurred if a potential loss becomes an actual loss. An example is the cost of rebuilding and reequipping an assembly plant that burns to the ground. The second type consists of the costs of reducing or eliminating the risk of potential loss. Here we would include the cost of purchasing insurance against loss by fire or the cost of not building the plant at all (this cost is equal to the profit that the plant might have earned). These two types of costs must be balanced, one against the other, if risk management is to be effective.
Most people think of risk management as simply buying insurance. However, insurance, although an important part of risk management, is not the only means of dealing with risk. Other methods may be less costly in specific situations. And some kinds of risks are uninsurable—not even an insurance company will issue a policy to protect against them. In this section we examine the four general risk-management techniques. Then, in the following sections, we look more closely at insurance.

**Risk Avoidance**

An individual can avoid the risk of an automobile accident by not riding in a car. A manufacturer can avoid the risk of product failure by refusing to introduce new products. Both would be practicing risk avoidance—but at a very high cost. The person who avoids automobile accidents by foregoing cars may have to give up his or her job to do so. The business that does not take a chance on new products probably will fail when the product life cycle, discussed in Chapter 14, catches up with existing products.

There are, however, situations in which risk avoidance is a practical technique. At the personal level, individuals who stop smoking or refuse to walk through a dark city park late at night are avoiding risks. Jewelry stores lock their merchandise in vaults at the end of the business day to avoid losses through robbery. And to avoid the risk of a holdup, many gasoline stations accept only credit cards or the exact amount of the purchase for sales made after dark.

Obviously, no person or business can eliminate all risks. By the same token, however, no one should assume that all risks are unavoidable.

**Risk Reduction**

If a risk cannot be avoided, perhaps it can be reduced. An automobile passenger can reduce the risk of injury in an automobile accident by wearing a seat belt. A manufacturer can reduce the risk of product failure through careful product planning and market testing. In both situations, the cost of reducing risk seems to be well worth the potential saving.

Businesses face risks as a result of their operating procedures and management decision making. An analysis of operating procedures—by company personnel or outside consultants—often can point out areas in which risk can be reduced. Among the techniques that can be used are

- The establishment of an employee safety program to encourage employees’ awareness of safety
- The purchase and use of proper safety equipment, from hand guards on machinery to goggles and safety shoes for individuals
- Burglar alarms, security guards, and even guard dogs to protect warehouses from burglary
- Fire alarms, smoke alarms, and sprinkler systems to reduce the risk of fire and the losses due to fire
- Accurate and effective accounting and financial controls to protect a firm’s inventories and cash from pilfering

The risks involved in management decisions can be reduced only through effective decision making. These risks increase when a decision is made hastily or is based on less than sufficient information. However, the cost of reducing these risks goes up when managers take too long to make decisions. Costs also increase when managers require an overabundance of information before they are willing to decide.

**Risk Assumption**

An individual or firm will—and probably must—take on certain risks as part of living or doing business. Individuals who drive to work assume the risk of having an acci-
dent, but they wear a seat belt to reduce the risk of injury in the event of an accident. The firm that markets a new product assumes the risk of product failure—after first reducing that risk through market testing.

Risk assumption, then, is the act of taking responsibility for the loss or injury that may result from a risk. Generally, it makes sense to assume a risk when one or more of the following conditions exist:

1. The potential loss is too small to worry about.
2. Effective risk management has reduced the risk.
3. Insurance coverage, if available, is too expensive.
4. There is no other way of protecting against the loss.

Large firms with many facilities often find a particular kind of risk assumption, called self-insurance, a practical way to avoid high insurance costs. **Self-insurance** is the process of establishing a monetary fund that can be used to cover the cost of a loss. For instance, suppose that approximately 16,000 ABC convenience stores, each worth $400,000, are scattered around the country. A logical approach to self-insurance against fire losses would be to collect a certain sum—say, $600—from each store every year. The funds are placed in an interest-bearing reserve fund and used as necessary to repair any fire damage that occurs to ABC stores. Money not used remains the property of the firm. Eventually, if the fund grows, the yearly contribution from each store can be reduced.

Self-insurance does not eliminate risks; it merely provides a means for covering losses. And it is, itself, a risky practice—at least in the beginning. For example, ABC would suffer a considerable financial loss if more than twenty-four stores were destroyed by fire in the first year the self-insurance program was in effect.

**Shifting Risks**

Perhaps the most common method of dealing with risk is to shift, or transfer, the risk to an insurance company. An **insurer (or insurance company)** is a firm that agrees, for a fee, to assume financial responsibility for losses that may result from a specific risk. The fee charged by an insurance company is called a **premium**. A contract between an insurer and the person or firm whose risk is assumed is known as an **insurance policy**. Generally, an insurance policy is written for a period of one year. Then, if both parties are willing, it is renewed each year. It specifies exactly which risks are covered by the agreement, the dollar amounts the insurer will pay in case of a loss, and the amount of the premium.

**Insurance** is thus the protection against loss that the purchase of an insurance policy affords. Insurance companies will not, however, assume every kind of risk. A risk that insurance companies will assume is called an **insurable risk**. Insurable risks include the risk of loss by fire and theft, the risk of loss by automobile accident, and the risks of sickness and death. A risk that insurance companies will not assume is called an **uninsurable risk**.

In general, pure risks are insurable, whereas speculative risks are uninsurable (see Figure B.1). An insurance company will protect a Ford Motor Company assembly plant against losses due to fire or tornadoes. It will not, however, protect Ford against losses resulting from a lack of sales orders for automobiles.

The next section provides an overview of the basic principles of insurance and the kinds of companies that provide insurance.

**Insurance and Insurance Companies**

An insurance company is a business. Like other businesses, an insurer provides a product—protection from loss—in return for a reasonable fee. Its sales revenues are the premiums it collects from the individuals and firms it insures. (Insurance companies...
typically invest the money they have on hand; thus we should include interest and dividend income as part of their revenues.) Its expenses are the costs of the various resources—salaries, rent, utilities, and so on—plus the amounts the insurance company pays out to cover its clients’ losses.

The years 2001 and 2005 were difficult ones for the insurance industry. A surge of catastrophic claims after the September 11 terrorist attacks left the industry reeling. The terrorist attack was the largest single event in all segments of the insurance industry, including health, workers’ compensation, property, and airline liability insurance. In fact, catastrophic losses were the highest in the insurance industry’s history, amounting to approximately $50 billion in 2001. For the first time ever, insurance companies paid more for claims than they collected from premiums plus investment earnings.

In response to the unexpected rise in claims and weaker investment returns in the 2001–2002 bear market, the insurance companies cut back coverage and sharply increased premium rates. Terrorism coverage has become particularly difficult for both insurance companies and businesses. The 2005 hurricane season, the most costly disaster in U.S. history, resulted in record insurance losses. The year’s three most devastating hurricanes - Katrina, Rita, and Wilma - resulted in at least $45.2 billion in insured property losses and produced a record 2.8 million claims.

Pricing and product are very important and exacting issues to an insurance company primarily because it must set its price (its premiums) before knowing the specific cost of its product (the amount of money it will have to pay out in claims). For this reason, insurance companies employ mathematicians called actuaries to predict the likelihood of losses and to determine the premiums that should be charged. Let us look at some of the more important concepts on which insurance (and the work of actuaries) is based.
Basic Insurance Concepts

Insurance is based on several principles, including the principle of indemnity, insurability of the risk, and low-cost, affordable coverage.

The Principle of Indemnity

The purpose of insurance is to provide protection against loss; it is neither speculation nor gambling. This concept is expressed in the principle of indemnity: In the event of a loss, an insured firm or individual cannot collect from the insurer an amount greater than the actual dollar amount of the loss. Suppose that you own a home valued at $250,000. However, you purchase $300,000 worth of fire insurance on your home. Even if it is destroyed by fire, the insurer will pay you only $250,000, the actual amount of your loss.

The premiums set by actuaries are based on the amount of risk involved and the amount to be paid in case of a loss. Generally, the greater the risk and the amount to be paid, the higher is the premium.

Insurability of the Risk

Insurers will accept responsibility for risks that meet at least the following conditions:

1. *Losses must not be under the control of the insured.* Losses caused by fire, wind, or accident generally are insurable, but gambling losses are not. Nor will an insurer pay a claim for damage intentionally caused by the insured person. For example, a person who sets fire to an insured building cannot collect on a fire insurance policy.

2. *The insured hazard must be geographically widespread.* That is, the insurance company must be able to write many policies covering the same specific hazard throughout a wide geographic area. This condition allows the insurer to minimize its own risk: the risk that it will have to pay huge sums of money to clients within a particular geographic area in the event of a catastrophe caused, for example, by a tornado or an earthquake.

3. *The probability of a loss should be predictable.* Insurance companies cannot tell which particular clients will suffer losses. However, their actuaries must be able to determine, statistically, what fraction of their clients will suffer each type of loss. They can do so, for insurable risks, by examining records of losses for past years. They can then base their premiums, at least in part, on the number and value of the losses that are expected to occur.

4. *Losses must be measurable.* Insured property must have a value that is measurable in dollars because insurance firms reimburse losses with money. Moreover, premiums are based partly on the measured value of the insured property. As a result of this condition, insurers will not insure an item for its emotional or sentimental value but only for its actual monetary value.

5. *The policyholder must have an insurable interest.* That is, the individual or firm that purchases an insurance policy must be the one that would suffer from a loss. You can purchase insurance on your own home, but you cannot insure your neighbor’s home in the hope of making a profit if it should burn down! Generally, individuals are considered to have an insurable interest in their family members. Therefore, a person can insure the life of a spouse, a child, or a parent. Corporations may purchase “key executive” insurance covering certain corporate officers. The proceeds from this insurance help offset the loss of the services of these key people if they die or become incapacitated.

Low-Cost, Affordable Coverage

Price is usually a marketing issue rather than a technical concept. However, the price of insurance is intimately tied to the risks and potential losses involved in a particular type of coverage. Insurers would like to “produce” insurance at a very low cost to their policyholders, but they must charge enough in premiums to cover their expected payouts.

Using the Internet

There is a wide variety of websites that provide useful information about insurance, including the sites of insurance companies themselves. For authoritative quick tips and links to other relevant sites, visit the Insurance Information Institute website at http://iii.org.
Customers purchase insurance when they believe premiums are low in relation to the possible dollar loss. For certain risks, premiums can soar so high that insurance is simply not cost-effective. A $1,000 life insurance policy for a 99-year-old man would cost about $950 per year. Clearly, a man of that age would be better off if he invested the premium amount in a bank. He would thus be using self-insurance rather than shifting the risk. Although this is an extreme example, it illustrates that insurers must compete, through their prices, with alternative methods of managing risk.

**Ownership of Insurance Companies**

Insurance companies are owned either by stockholders or by policyholders. A **stock insurance company** is owned by stockholders and is operated to earn a profit. Like other profit-making corporations, stock insurance companies pay dividends to stockholders from surplus of income (left over after benefit payments, operating expenses, and taxes have been paid). Most of the approximately 6,000 insurance companies in the United States are stock insurance companies.

A **mutual insurance company** is owned collectively by its policyholders and is thus a cooperative. Because a mutual insurance company has no stockholders, its policyholders elect the board of directors. The members of the board, in turn, choose the executives who manage the firm. Any surplus of income over expenses is distributed to policyholders as a return of part of their premiums. (This return may take the form of a reduced premium at the start of the policy year or of a “dividend” at the end of the policy year.)

Both stock and mutual insurance companies must maintain cash reserves to cover future obligations and policyholders’ claims. Cash reserves typically are invested in certificates of deposit, stocks, bonds, and real estate.

**Careers in Insurance**

Insurance companies form one of the largest industries in the United States. The industry ranks in importance with banking and finance, manufacturing, building, and electronics. Careers in insurance generally fall into two categories: sales and administration.

In the sales category, individuals can work as employees of insurance companies or as independent agents representing more than one insurance company. Recently, the insurance industry has placed more emphasis on advanced training for sales personnel. Life insurance salespeople who pass examinations and meet other requirements are awarded the Chartered Life Underwriter (CLU) designation. The Chartered Property Casualty Underwriter (CPCU) designation is awarded to individuals who pass examinations and meet the requirements in all areas except life insurance.

Administrative employees work to meet the needs of the firm’s customers. They must process policies and claims and handle an amazing amount of paperwork. Jobs in this category include actuary, claims adjuster, claims clerk, underwriter, and a number of other essential positions. In addition to meeting the needs of customers, administrative employees are responsible for investing funds for an insurance company.

**Property and Casualty Insurance**

Businesses and individuals insure their property, such as buildings, against losses and purchase casualty insurance to cover financial losses resulting from injuries or damage caused by automobile accidents.

Insurance is available to cover most pure risks, but specialized or customized policies can be expensive. A part of effective risk management is to ensure that when
insurance is purchased, the coverage is proper for the individual situation. Three questions can be used as guidelines in this regard:

- What hazards must be insured against?
- Is the cost of insurance coverage reasonable in this situation?
- What other risk-management techniques can be used to reduce insurance costs?

## Fire Insurance

Fire insurance covers losses due to fire. The standard fire insurance policy provides protection against partial or complete loss of a building and/or its contents when that loss is caused by fire or lightning. Premiums depend on the construction of the building, its use and contents, whether risk-reduction devices (such as smoke and fire alarms) are installed in the building, and other factors. If a fire occurs, the insurance company reimburses the policyholder for either the actual dollar loss or the maximum amount stated in the policy, whichever is lower.

### Coinsurance Clause

To reduce their insurance premiums, individuals and businesses sometimes insure property for less than its actual cash value. Their theory is that fire rarely destroys a building completely—thus they need not buy full insurance. However, if the building is partially destroyed, they expect their insurance to cover all the damage. This places an unfair burden on the insurance company, which receives less than the full premium but must cover the full loss. To avoid this problem, insurance companies include a coinsurance clause in most fire insurance policies.

A **coinsurance clause** is a part of a fire insurance policy that requires the policyholder to purchase coverage at least equal to a specified percentage of the replacement cost of the property to obtain full reimbursement for losses. In most cases, the requirement is 80 percent of the replacement cost. Suppose that the owners of a $600,000 building decide to purchase only $300,000 worth of fire insurance. If the building is totally destroyed, the insurance company must pay the policy’s face value of $300,000. However, if the building is only partially destroyed, and the damage amounts to $200,000, the insurance company will pay only $125,000. This dollar amount is calculated in the following manner:

1. The coinsurance clause requires coverage of at least 80 percent of $600,000, or $480,000.
2. The owners have purchased only $300,000 of insurance. Thus they have insured themselves for only a portion of any loss. That portion is $300,000 ÷ $480,000 = 0.625, or 62.5 percent.
3. The insurance company therefore will reimburse the owner for only 62.5 percent of any loss. In the case of a $200,000 loss, the insurance company will pay 62.5 percent of $200,000, or $125,000.

If the owners of the building had insured it for $480,000, the insurance company would have covered the entire $200,000 loss.

### Extended Coverage

**Extended coverage** is insurance protection against damage caused by wind, hail, explosion, vandalism, riots or civil commotion, falling aircraft, and smoke. Extended coverage is available as an endorsement, or addition, to some other insurance policy—usually a fire insurance policy. The premium for extended coverage is generally quite low (much lower than the total cost of separate policies covering each individual hazard). Normally, losses caused by war, nuclear radiation or contamination, and water (other than in storms and floods) are excluded from extended-coverage endorsements.

## Burglary, Robbery, and Theft Insurance

**Burglary** is the illegal taking of property through forcible entry. A kicked-in door, a broken window pane, or pry marks on a windowsill are evidence of a burglary or
attempted burglary. Robbery is the unlawful taking of property from an individual by force or threat of violence. A thief who uses a gun to rob a gas station is committing robbery. Theft (or larceny) is a general term that means the wrongful taking of property that belongs to another. Insurance policies are available to cover burglary only, robbery only, theft only, or all three. Premiums vary with the type and value of the property covered by the policy.

Business owners also must be concerned about crimes that employees may commit. A fidelity bond is an insurance policy that protects a business from theft, forgery, or embezzlement by its employees. If such a crime does occur, the insurance company reimburses the business for financial losses up to the dollar amount specified in the policy. Individual employees or specific positions within an organization may be bonded. It is also possible to purchase a “blanket” policy that covers the entire work force. Fidelity bonds are purchased most commonly by banks, savings and loan associations, finance companies, and other firms whose employees handle cash on a regular basis.

Although business owners are concerned about shoplifting, they often find that insurance coverage, if available, is too expensive. And it is often difficult to collect on losses resulting from shoplifting because such losses are difficult to prove.

Motor Vehicle Insurance

Individuals and businesses purchase automobile insurance because it is required by state law, because it is required by the firm financing the purchase of the vehicle, and/or because they want to protect their investment. Most types of automobile coverage can be broadly classified as either liability or physical damage insurance. Table B.1 shows the distinction.

Automobile Liability Insurance

Automobile liability insurance is insurance that covers financial losses resulting from injuries or damage caused by the insured vehicle. Most automobile policies have a liability limit that contains three numbers. For example, the liability limits stated on a policy might be 100/300/50. The first two numbers indicate the maximum amounts, in thousands of dollars, the insurance company will pay for bodily injury. Bodily injury liability coverage pays medical bills and other costs in the event that an injury or death results from an automobile accident in which the policyholder is at fault. Bodily injury liability coverage protects the person in the other car and usually is specified as a pair of dollar amounts. In the preceding example, the policy limits are $100,000 for each person and $300,000 for each occurrence. This means that the insurance company will pay up to $100,000 to each person injured in an accident and up to a total of $300,000 to all those injured in a single accident. Coverage limits can be as low as the state requires and as high as $500,000 per person and $1 million per accident. Payment for additional damage above the policy limits is the responsibility of the insured. In view of the cost of medical care today, and considering the size of legal settlements resulting from automobile accidents, insurance companies recommend coverage of at least $100,000 per person and $300,000 per occurrence.

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<td>Liability insurance covers financial losses resulting from injuries or damage caused by the insured vehicle; physical damage insurance covers damage to the insured vehicle.</td>
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<td><strong>Liability Insurance</strong></td>
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Property damage liability coverage pays for the repair of damage that the insured vehicle does to the property of another person. Such damage is covered up to the amount specified in the policy. In the preceding example, the third number (50) indicates that the insurance company will pay up to $50,000 to repair property damage. Insurance companies generally recommend at least $100,000 worth of property damage liability.

Along with other automobile liability insurance, most car owners also purchase protection for the passengers in their own cars. A medical payments endorsement can be included in automobile coverage for a small additional premium. This endorsement provides for the payment of medical bills, up to a specified amount, for passengers (including the policyholder) injured in the policyholder’s vehicle. Most insurers sell this coverage in increments of $1,000 or $5,000, up to $25,000. There is no deductible.

Automobile Physical Damage Insurance Liability insurance does not pay for the repair of the insured vehicle. Automobile physical damage insurance is insurance that covers damage to the insured vehicle. Collision insurance pays for the repair of damage to the insured vehicle as a result of an accident. Most collision coverages include a deductible amount—anywhere from $100 up—that the policyholder must pay. The insurance company then pays either the remaining cost of the repairs or the actual cash value of the vehicle (when the vehicle is “totaled”), whichever is less. For most automobiles, collision insurance is the most costly coverage. Premiums can be reduced, however, by increasing the deductible amount.

Comprehensive insurance covers damage to the insured vehicle caused by fire, theft, hail, dust storm, vandalism, and almost anything else that could damage a car, except collision and normal wear and tear. With the possible exception of CB radios and GPS systems that are installed by the owner of the car, even the contents of the car are insured. For example, comprehensive coverage will pay for a broken windshield, stolen hubcaps, or small dents caused by a hailstorm. Like collision coverage, comprehensive coverage includes a deductible amount, usually up to $1,000.

Uninsured motorists insurance covers the insured driver and passengers from bodily injury losses (and in some states, property damage losses) resulting from an accident caused by a driver with no liability insurance. It also covers damage caused by a hit-and-run driver. In some states and with some insurance companies, uninsured motorists coverage is not automatically included in a typical policy. And yet it is important coverage that is quite reasonable. Often, annual premiums are about $100.

No-Fault Auto Insurance No-fault auto insurance is a method of paying for losses suffered in an automobile accident. It is enacted by state law and requires that those suffering injury or loss be reimbursed by their own insurance companies, without regard to who was at fault in the accident. Although there are numerous exceptions, most no-fault laws also limit the rights of involved parties to sue each other.

Massachusetts enacted the first no-fault law in 1971 in an effort to reduce both auto insurance premiums and the crushing caseload in its court system. Since then, at least thirteen states have followed suit. Every state with a no-fault law requires coverage for all vehicles registered in the state.

Business Liability Insurance

Business liability coverage protects the policyholder from financial losses resulting from an injury to another person or damage to another person’s property. During the past fifteen years or so, both the number of liability claims and the size of settlements have increased dramatically. The result has been heightened awareness of the need for liability coverage—along with quickly rising premiums for this coverage.

Public liability insurance protects the policyholder from financial losses due to injuries suffered by others as a result of negligence on the part of a business owner or employee. It covers injury or death resulting from hazards at the place of business or from the actions of employees. For example, liability claims totaling more than $2 billion...
were filed on behalf of the victims of the 1981 skybridge collapse at the Hyatt Regency Hotel in Kansas City, Missouri. More recent examples in which damage claims totaled more than a billion dollars include the chemical accident at Union Carbide’s plant in Bhopal, India; the 1987 Du Pont Hotel fire in San Juan, Puerto Rico; and the $368-billion tobacco industry settlement in 1997. Malpractice insurance, which is purchased by physicians, lawyers, accountants, engineers, and other professionals, is a form of public liability insurance.

Product liability insurance protects the policyholder from financial losses due to injuries suffered by others as a result of using the policyholder’s products. Recent court settlements for individuals injured by defective products have been extremely large. In 2005, a Texas jury found Merck and Co. liable in the death of a Vioxx user, Robert Ernst, a 59-year-old amateur athlete, and awarded his widow $250 million in damages. (Merck insists that under Texas law, the maximum award is $26 million. Merck was expected to appeal the verdict.)

Some juries have found manufacturers and retailers guilty of negligence even when the consumer used the product incorrectly. This development and the very large awards given to injured consumers have caused management to take a hard look at potential product hazards. As part of their risk-management efforts, most manufacturers now take the following precautions:

1. They include thorough and explicit directions with products.
2. They warn customers about the hazards of using products incorrectly.
3. They remove from the market those products that are considered hazardous.
4. They test products in-house to determine whether safety problems can arise from either proper or improper use.

Such precautions can reduce both the risk of product liability losses and the cost of liability insurance. When the risk of death, injury, or lawsuits cannot be eliminated or at least reduced, some manufacturers simply have discontinued the product.

Marine (Transportation) Insurance

Marine, or transportation, insurance provides protection against the loss of goods that are being shipped from one place to another. It is the oldest type of insurance, having originated with the ancient Greeks and Romans. The term marine insurance was coined at a time when only goods transported by ship were insured.

Today marine insurance is available for goods shipped over water or land. Ocean marine insurance protects the policyholder against loss or damage to a ship or its cargo on the high seas. Inland marine insurance protects against loss or damage to goods shipped by rail, truck, airplane, or inland barge. Both types cover losses from fire, theft, and most other hazards.

Business Interruption Insurance

Business interruption insurance provides protection for a business whose operations are interrupted because of a fire, storm, or other natural disaster. It is even possible to purchase coverage to protect a firm if its employees should go out on strike. For most businesses, interruption coverage is available as an endorsement to a fire insurance policy. Premiums are determined by the amount of coverage and the risks that are covered.

The standard business interruption policy reimburses the policyholder for both loss of profit and fixed costs in the event that it cannot operate. Profit payments are based on profits earned by the firm during some specified period. Fixed-cost payments cover expenses the firm incurs even when it is not operating. Employee salaries normally are not covered by the standard policy. However, they may be included for an increased premium.
Public and Employer-Sponsored Insurance for Individuals

Both the government and private insurance companies offer a number of different types of coverage for individuals in the United States. In this section we discuss Social Security, unemployment insurance, workers’ compensation, and medical insurance.

Public Insurance

Federal and state governments offer insurance programs to meet the specific needs of individuals who are eligible for coverage. The Social Security program, established by the Social Security Act of 1935, today provides benefits for more than forty-five million people, almost one out of every six Americans. The Social Security program—financed by taxes paid by both employees and employers—actually consists of four programs. First, retirement benefits are paid to eligible employees and self-employed individuals when they reach age 65. They can obtain reduced benefits at age 62. Second, survivor benefits are paid to a worker’s spouse, dependent children, or in some cases dependent parents when a covered worker dies before retirement. Third, disability benefits are paid to workers who are severely disabled and unable to work. Benefits continue until it is determined that the individual is no longer disabled. When a disabled worker reaches age 65, the worker is then eligible for retirement benefits. Fourth, the Medicare program provides hospital, medical, and drug coverage. Workers can be covered when they reach age 65. Persons who have received disability benefits for a period of at least twenty-four months are also eligible for Medicare coverage.

Unlike the federal Social Security program, unemployment insurance is a joint program between the federal and state governments. The purpose of the program is to provide benefits (employment services and money) to unemployed workers. The dollar amount and the duration of benefits are determined by state laws. The program is funded by a tax paid by employers.

Workers’ Compensation

Workers’ compensation insurance covers medical expenses and provides salary continuation for employees who are injured while at work. This insurance also pays benefits to the dependents of workers killed on the job. Every state now requires employers to provide some form of workers’ compensation insurance; specific benefits are established by the state. Employers may purchase this type of insurance from insurance companies or, in some cases, from the state. Self-insurance also can be used to meet requirements in a few states. State laws do vary; some are more stringent than others. In fact, the low cost of workers’ compensation in some states is one of many reasons businesses might choose to locate or move there.

Salary continuation payments to employees unable to work because of injuries sustained on the job normally range from 60 to 75 percent of an employee’s usual wage. They may, however, be limited to a specified number of payments. In all cases, they stop when the employee is able to return to work.

Workers’ compensation premiums, paid by the employer, generally are computed as a small percentage of each employee’s wages. The percentage varies with the type of job and is, in general, higher for jobs that involve greater risk of injury.

Health Care Insurance

Today, most employers pay, as an employee benefit, part or all of the cost of health care insurance for employees. When the employer does not pay for coverage, most individuals purchase their own health care insurance—when they can afford the coverage.
Health care insurance covers the cost of medical attention, including hospital care, physicians’ and surgeons’ fees, prescription medicines, and related services. In addition, some firms also provide employees with dental and life insurance. Major medical insurance also can be purchased to extend medical coverage beyond the dollar limits of the standard health care insurance policy. In all cases, the types of coverage and the premiums vary according to the provisions of the specific health care policy, whether it is paid for by the employer or the individual.

The cost of medical care has been increasing over the last forty years. National expenditures for health care in 2005 were more than $1.92 trillion, or over $7,761 per individual, according to the Centers for Medicare and Medical Services. Thus about 14 percent of our gross domestic product is spent on health care. In an attempt to keep medical insurance premiums down, insurers have developed a variety of insurance plans that are less expensive than full-coverage plans. Some plans have deductibles of $500 to $1,000. Some require that the policyholder pay 20 to 30 percent of the first $1,000 to $3,000 in medical bills. And some pay the entire hospital bill but only a percentage of other medical expenses. One additional method that can reduce the cost of health care coverage is the use of a health maintenance organization. A health maintenance organization (HMO) is an insurance plan that directly employs or contracts with selected physicians and hospitals to provide health care services in exchange for a fixed, prepaid monthly premium. Although there have been concerns about the quality of care provided by some HMOs, they are expected to grow because they offer a lower-cost alternative to traditional health care plans.

Preferred provider organizations (PPOs) offer the services of doctors and hospitals at discount rates or give breaks in copayments (the portion of the bill the insured must pay each time services are used) and deductibles. An insurance company or an employer contracts with a PPO to provide specified services at predetermined fees to PPO members.

Life Insurance

Life insurance pays a stated amount of money on the death of the insured individual. The money is paid to one or more beneficiaries. A beneficiary is a person or organization named in a life insurance policy as a recipient of the proceeds of that policy on the death of the insured.

Life insurance thus provides protection for the beneficiaries of the insured. The amount of insurance needed depends very much on their situation. A wage earner with three small children generally needs more life insurance than someone who is single. Moreover, the need for life insurance changes as a person’s situation changes. When the wage earner’s children are grown and on their own, they need less protection (through their parent’s life insurance) than they did when they were young.

For a particular dollar amount of life insurance, premiums depend primarily on the age of the insured and on the type of insurance. The older a person is, the higher is the premium. (On average, older people are less likely to survive each year than younger persons.) Finally, insurers offer several types of life insurance for customers with varying insurance needs. The price of each type depends on the benefits it provides.

Term Life Insurance

Term life insurance provides protection to beneficiaries for a stated period of time. Because term life insurance includes no other benefits, it is the least expensive form of life insurance. It is especially attractive to young married couples who want as much protection as possible but cannot afford the higher premiums charged for other types of life insurance.

Most term life policies are in force for a period of one year. At the end of each policy year, a term life policy can be renewed at a slightly higher cost—to take into ac-
count the fact that the insured individual has aged one year. In addition, some term policies can be converted into other forms of life insurance at the option of the policyholder. This feature permits policyholders to modify their insurance protection to keep pace with changes in their personal circumstances.

Whole Life Insurance

Whole life insurance, also called ordinary life insurance, provides both protection and savings. In the beginning, premiums generally are higher than those for term life insurance. However, premiums for whole life insurance remain constant for as long as the policy is in force.

A whole life policy builds up savings over the years. These savings are in the form of a cash surrender value, which is the amount payable to the holder of a whole life insurance policy if the policy is canceled. In addition, the policyholder may borrow from the insurance company, at a relatively low interest rate, amounts up to the policy’s cash surrender value.

Whole life insurance policies are sold in these three forms:

- Straight life insurance, for which the policyholder must pay premiums as long as the insured is alive
- Limited-payment life insurance, for which premiums are paid for only a stated number of years
- Single-payment life insurance, for which one lump-sum premium is paid at the time the insurance is purchased

Which of these is best for a given individual depends, as usual, on that individual’s particular situation and insurance needs.

Endowment Life Insurance

Endowment life insurance provides protection and guarantees the payment of a stated amount to the policyholder after a specified number of years. Endowment policies generally are in force for twenty years or until the insured person reaches age 65. If the insured dies while the policy is in force, the beneficiaries are paid the face amount of the policy. However, if the insured survives through the policy period, the stated amount is paid to the policyholder.

The premiums for endowment policies generally are higher than those for whole life policies. In return, the policyholder is guaranteed a future payment. Thus the endowment policy includes a sort of “enforced savings” feature. In addition, the cash surrender values of endowment policies usually are higher than those of whole life policies.

Universal Life Insurance

Universal life insurance combines insurance protection with an investment plan that offers a potentially greater return than that guaranteed by a whole life insurance policy. Universal life insurance is the newest product available from life insurance companies. It offers policyholders several options unavailable with other types of policies. For example, policyholders may choose to make larger or smaller premium payments, to increase or decrease their insurance coverage, or even to withdraw the policy’s cash value without canceling the policy. Essentially, the purchase of universal life insurance combines the purchase of annual term insurance with the buying and selling of investments.

Universal life insurance generally offers lower premiums than whole life insurance. In fact, the premium is often called a contribution. However, companies that offer universal life insurance may charge a fee when the policy is first purchased, each time an annual premium is paid, and when funds are withdrawn from the policy’s cash value. Such fees tend to decrease the return on the savings account part of the policy.
Our initial task in this appendix is to examine the sources of laws and the functions of federal and state court systems. Next, we discuss the major categories of laws that apply to business activities: contract law, property law, and laws relating to negotiable instruments, the agent-principal relationship, and bankruptcy. Then we describe federal laws that encourage competition, and we look at the issue of deregulation of business. We conclude with a discussion of federal, state, and local taxes—the primary means by which all governments finance their activities.

Laws and the Courts

A law is a rule developed by a society to govern the conduct of and relationships among its members. Laws set standards of behavior for both businesses and individuals. They establish the rights of parties in exchanges and various types of agreements. Laws provide remedies in the event that one business (or individual) believes that it has been injured by another. In the United States, the supreme law of the land is the U.S. Constitution. The federal, state, and local governments enact and administer laws, but no law is valid if it violates the Constitution.

Sources of Laws

Each level of government derives its laws from two major sources: (1) judges’ decisions, which make up common law, and (2) legislative bodies, which enact statutory laws.

Common Law

Common law, also known as case law or judicial law, is the body of law created by court decisions rendered by judges. Common law began as custom and tradition in England. It was then transported to America during the colonial period and, since then, has been further enlarged by the decisions of American judges.

The growth of common law is founded on the doctrine of stare decisis, a Latin term meaning “to stand by a previous decision.” The doctrine of stare decisis is a practical source of law for two reasons. First, a judge’s decision in a case may be used by other judges as the basis for later decisions. The earlier decision thus has the strength of law and is, in effect, a source of law. Second, the doctrine of stare decisis makes law more stable and predictable. If someone brings a case to court and the facts are the same as those in a case that has already been decided, the court will make a decision based on the previous legal decision. The court may depart from the doctrine of stare decisis if the facts in the current case differ from those in an earlier case or if business practices, technology, or the attitudes of society have changed.

Statutory Law

A statute is a law passed by the U.S. Congress, a state legislature, or a local government. Statutory law, then, consists of all the laws that have been enacted by legislative bodies. For businesses, one very important part of statutory law is the Uniform Commercial Code. The Uniform Commercial Code (UCC) is a set of laws designed to eliminate differences among state regulations affecting business and to simplify interstate commerce. The UCC consists of eleven articles, or chapters, that cover sales, commercial paper, bank deposits and collections, letters of credit, transfers of title, securities, and transactions that involve collateral. It has been adopted with variations in all fifty states. The state statutes that the UCC replaced varied from state to state and caused problems for firms that did business in more than one state.
Today, most legal experts have expanded the concept of statutory law to include administrative law. **Administrative law** consists entirely of the regulations created by government agencies established by legislative bodies. The Nuclear Regulatory Commission, for example, has the power to set specific requirements for nuclear power plants. It can even halt the construction or operation of plants that do not meet such requirements. These requirements thus have the force and effect of law.

Most regulatory agencies hold hearings that are similar to court trials. Evidence is introduced, and the parties are represented by legal counsel. Moreover, the decisions of these agencies may be appealed in state or federal courts.

### Public Law and Private Law: Crimes and Torts

**Public law** is the body of law that deals with the relationships between individuals or businesses and society. A violation of a public law is called a **crime**. Among the crimes that can affect a business are the following:

- Burglary, robbery, and theft
- Embezzlement, or the unauthorized taking of money or property by an employee, agent, or trustee
- Forgery, or the false signing or changing of a legal document with the intent to alter the liability of another person
- The use of inaccurate weights, measures, or labels
- The use of the mails to defraud, or cheat, an individual or business
- The receipt of stolen property
- The filing of a false and fraudulent income tax return

Those accused of violating public laws—or committing crimes—are prosecuted by a federal, state, or local government.

**Private law** is the body of law that governs the relationships between two or more individuals or businesses. A violation of a private law is called a **tort**. In some cases a single illegal act—such as embezzlement—can be both a crime and a tort.

Torts may result either from intentional acts or from negligence. Such acts as shoplifting and embezzlement are intentional torts. **Negligence**, on the other hand, is a failure to exercise reasonable care, resulting in injury to another. Suppose that the driver of a delivery truck loses control at the wheel and rams into a building. A tort has been committed, and the owner of the building may sue both the driver and the driver’s employer to recover the cost of repairing the damage. Among the torts that can affect a business are the following:

- **Slander**—A false oral statement that injures a person’s or business’s reputation
- **Libel**—A false written statement that injures a person’s or business’s reputation
- **Fraud**—A misrepresentation of facts designed to take advantage of another individual or business
- **Product liability**—A manufacturer’s responsibility for negligence in designing, manufacturing, or providing operating instructions for its products
- **Personal injury**—Damage caused by accidents, intentional acts, or defective products
- **Unfair competitive practices**—Behavior of an entity that unfairly lessens another organization’s ability to compete

The purpose of private law is to provide a remedy for the party injured by a tort. In most cases the injured party must bring a legal action and present the facts in a court of law. Either a judge or jury will then render a decision. In most cases the remedy consists of monetary damages to compensate the injured party and punish the person committing the tort. For example, the courts ruled that Eastman Kodak committed a tort by infringing on certain patent rights owned by Polaroid. Eastman Kodak was forced to pay Polaroid almost $900 million in damages. Because large dollar settlements have become commonplace, many business owners and politicians insist that there is a need for tort reform.
The Court System

The United States has two separate and distinct court systems. The federal court system consists of the Supreme Court of the United States, which was established by the Constitution, and other federal courts that were created by Congress. In addition, each of the fifty states has established its own court system. Figure C.1 shows both the federal court system and a typical state court system.

The Federal Court System  Federal courts generally hear cases that involve

- Questions of constitutional law
- Federal crimes or violations of federal statutes
- Property valued at $75,000 or more in dispute between citizens of different states or between a U.S. citizen and a foreign nation
- Bankruptcy; the Internal Revenue Service (IRS); the postal laws; or copyright, patent, and trademark laws
- Admiralty and maritime cases

The United States is divided into federal judicial districts. Each state includes at least one district court, and more populous states have two or more. A district court is a court of original jurisdiction, which is the first court to recognize and hear testimony in a legal action. In many cases the decision reached in the district court may be appealed to a higher court. A court that hears cases appealed from lower courts is called an appellate court. If the appellate court finds the lower court’s ruling to be in error, it may reverse that ruling, modify the decision, or return the case to the lower court for a new trial. Currently, there are thirteen U.S. courts of appeal.

The U.S. Supreme Court—the highest court in the land—consists of nine justices (the chief justice and eight associate justices). The Supreme Court has original jurisdiction in cases that involve ambassadors and consuls and in certain cases involving one or more states. However, its main function is to review decisions made by the U.S. courts of appeal and, in some cases, by state supreme courts.

The State Court Systems  The state court systems are quite similar to the federal system in structure. All have courts of original jurisdiction and supreme courts, and most have intermediate appellate courts as well. The decision of a state supreme court may be appealed to the U.S. Supreme Court if it involves a question of constitutional or federal law.

Other Types of Courts  Other courts have been created to meet special needs at both the federal and state levels. A court of limited jurisdiction hears only specific types of cases. At the federal level, for example, Congress has created courts to hear cases that involve international trade, taxes and disputes with the IRS, and bankruptcy. At the state level, there are small-claims courts, which hear cases involving claims for less than a specified dollar amount (usually $1,000 or $5,000, depending on the state), traffic courts, divorce courts, juvenile courts, drug courts, mental health courts, and probate courts.
Contract Law

Contract law is perhaps the most important area of business law because contracts are so much a part of doing business. Every business person should understand what a valid contract is and how a contract is fulfilled or violated.

A contract is a legally enforceable agreement between two or more competent parties who promise to do or not to do a particular thing. An implied contract is an agreement that results from the actions of the parties. For example, a person who orders dinner at a local Chili's restaurant assumes that the food will be served within a reasonable time and will be fit to eat. The restaurant owner, for his or her part, assumes that the customer will pay for the meal.

Most contracts are more explicit and formal than that between a restaurant and its customers. An expressed contract is one in which the parties involved have made oral or written promises about the terms of their agreement.

Requirements for a Valid Contract

To be valid and legally enforceable, a contract must meet five specific requirements as follows: (1) voluntary agreement, (2) consideration, (3) legal competence of all parties, (4) lawful subject matter, and (5) proper form.

Voluntary Agreement  Voluntary agreement consists of both an offer by one party to enter into a contract with a second party and acceptance by the second party of all the terms and conditions of the offer. If any part of the offer is not accepted, there is no contract. And if it can be proved that coercion, undue pressure, or fraud was used to obtain a contract, it may be voided by the injured party.

Consideration  A contract is a binding agreement only when each party provides something of value to the other party. The value or benefit that one party furnishes to the other party is called consideration. This consideration may be money, property, a service, or the promise not to exercise a legal right. However, the consideration given by one party need not be equal in dollar value to the consideration given by the other party. As a general rule, the courts will not void a contract just because one party got a bargain.

Legal Competence  All parties to a contract must be legally competent to manage their own affairs and must have the authority to enter into binding agreements. The intent of the legal competence requirement is to protect individuals who may not have been able to protect themselves. The courts generally will not require minors, persons of unsound mind, or those who entered into contracts while they were intoxicated to comply with the terms of their contracts.

Lawful Subject Matter  A contract is not legally enforceable if it involves an unlawful act. Certainly, a person who contracts with an arsonist to burn down a building cannot go to court to obtain enforcement of the contract. Equally unenforceable is a contract that involves usury, which is the practice of charging interest in excess of the maximum legal rate. Other contracts that may be unlawful include promissory notes resulting from illegal gambling activities, contracts to bribe public officials, agreements to perform services without required licenses, and contracts that restrain trade or eliminate competition.

Proper Form of Contract  Businesses generally draw up all contractual agreements in writing so that differences can be resolved readily if a dispute develops. Figure C.2 shows that a contract need not be complicated to be legally enforceable.

A written contract must contain the names of the parties involved, their signatures, the purpose of the contract, and all terms and conditions to which the parties
have agreed. Any changes to a written contract should be made in writing, initialed by all parties, and attached to the original contract.

The Statute of Frauds, which has been passed in some form by all states, requires that certain types of contracts be in writing to be enforceable. These include contracts dealing with

- The exchange of land or real estate
- The sale of goods, merchandise, or personal property valued at $500 or more
- The sale of securities, regardless of the dollar amount
- Acts that will not be completed within one year after the agreement is made
- A promise to assume someone else’s financial obligation
- A promise made in contemplation of marriage

**Performance and Nonperformance**

Ordinarily, a contract is terminated by performance, which is the fulfillment of all obligations by all parties to the contract. Occasionally, however, performance may become impossible. Death, disability, or bankruptcy, for example, may legally excuse one party from a contractual obligation. However, what happens when one party simply does not perform according to a legal contract? A breach of contract is the failure of one party to fulfill the terms of a contract when there is no legal reason for that failure. In such a case it may be necessary for the other parties to the contract to bring legal action to discharge the contract, obtain monetary damages, or require specific performance.

**Discharge by mutual assent** is the termination of a contract when all parties agree to void a contract. Any consideration received by the parties must be returned when a contract is discharged by mutual assent.

**Damages** are a monetary settlement awarded to a party injured through a breach of contract. When damages are awarded, an attempt is made to place the injured party in the position it would be in if the contract had been performed.
Specific performance is the legal requirement that the parties to a contract fulfill their obligations according to the contract. Generally, the courts require specific performance if a contract calls for a unique service or product unobtainable from another source.

Most individuals and firms enter into a contract expecting to live up to its terms. Very few end up in court. When they do, it is usually because one or more of the parties did not understand all the conditions of the agreement. Thus it is imperative to know what you are signing before you sign it. If you have any doubt, get legal help! A signed contract is very difficult—and often very costly—to void.

Sales Agreements

A sales agreement is a special (but very common) type of contract by which ownership is transferred from a seller to a buyer. Article 2 of the UCC (entitled “Sales”) provides much of our sales law, which is derived from both common and statutory law. Among the topics included in Article 2 are rights of the buyer and seller, acceptance and rejection of an offer, inspection of goods, delivery, transfer of ownership, and warranties.

Article 2 also provides that a sales agreement may be binding even when one or more of the general contract requirements are omitted. For example, a sales agreement is legally binding when the selling price is left out of the agreement. Article 2 requires that the buyer pay the reasonable value of the goods at the time of delivery. Key considerations in resolving such issues are the actions and business history of the parties and any customary sales procedures within the particular industry.

Finally, Article 2 deals with warranties—both express and implied. As we saw in Chapter 14, an express warranty is a written explanation of the responsibilities of the producer (or seller) in the event that a product is found to be defective or otherwise unsatisfactory. An implied warranty is a guarantee imposed or required by law. In general, the buyer is entitled to assume that

1. The merchandise offered for sale has a clear title and is not stolen.
2. The merchandise is as advertised.
3. The merchandise will serve the purpose for which it was manufactured and sold.

Any limitation to an express or implied warranty must be clearly stated so that the buyer can understand any exceptions or disclaimers.

Other Laws That Affect Business

In addition to contract law, many other kinds of law affect the way a firm does business. In this section we describe the impact of laws relating to property, negotiable instruments, the agent-principal relationship, and bankruptcy on the day-to-day operations of a business firm.

Property Law

Property is anything that can be owned. The concept of private ownership of property is fundamental to the free-enterprise system. Our Constitution guarantees to individuals and businesses the right to own property and to use it in their own best interests.

Kinds of Property Property is legally classified as either real property or personal property. Real property is land and anything permanently attached to it. The term also applies to water on the ground and minerals and natural resources beneath the surface. Thus a house, a factory, a garage, and a well are all considered real property.
The degree to which a business is concerned with real property law depends on its size and the kind of business it is. The owner of a small convenience store needs only a limited knowledge of real property law. However, a national grocery-store chain such as Albertson’s might employ several real estate experts with extensive knowledge of real property law, property values, and real estate zoning ordinances throughout the country.

**Personal property** is all property other than real property. Personal property that has physical or material value—such as inventories, equipment, store fixtures, an automobile, or a book—is referred to as **tangible personal property** because it is movable and can be felt, tasted, or seen. Property that derives its value from a legal right or claim is called **intangible personal property**. Examples include stocks and bonds, receivables, trademarks, patents, and copyrights.

A **trademark** is a brand that is registered with the U.S. Patent and Trademark Office. Registration guarantees the owner the exclusive use of the trademark for 20 years, plus unlimited renewal terms. The owner may at times have to defend the trademark from unauthorized use—usually through legal action. McDonald’s was forced to do exactly that when the trademark “Big Mac” was used by another fast-food outlet in a foreign country.

A **patent** is the exclusive right to make, use, or sell or to license others to make and sell a newly invented product or process. Patents are granted by the U.S. Patent and Trademark Office for a period of seventeen years. After that period has elapsed, the invention becomes available for general use.

A **copyright** is the exclusive right to publish, perform, copy, or sell an original work. Copyright laws cover fiction and nonfiction, plays, poetry, musical works, photographs, films, and computer programs. For example, the copyright on this textbook is held by the publisher, Houghton Mifflin Company. The copyright on the movie The Lion King is held by Walt Disney. A copyright is usually held by the creator or the owner of the work and is generally in effect for the lifetime of the creator or owner plus seventy years. The copyright for certain works, including those created for an employer, lasts 120 years from creation or 95 years from publication, whichever occurs first.

**Laws Relating to Negotiable Instruments**

A **negotiable instrument** is a written document that (1) is a promise to pay a stated sum of money and (2) can be transferred from one person or firm to another. In effect, there are three types of negotiable instruments:

- **Deed** is a written document by which the ownership of real property is transferred from one person or organization to another. A deed must contain the names of the previous owner and the new owner, as well as a legally acceptable description of the property being transferred. A **lease** is an agreement by which the right to use real property is temporarily transferred from its owner, the landlord, to a tenant. In return for use of the property, the tenant generally pays rent on a weekly, monthly, or yearly basis. A lease is granted for a specific period of time, after which a new lease may be negotiated. If the lease is terminated, the right to use the real property reverts to the landlord.

Transfer of ownership for personal property usually involves either a purchase, a gift, or an inheritance. As we noted earlier, the Statute of Frauds requires that exchanges of real estate be in writing. A **deed** is a written document by which the ownership of real property is transferred from one person or organization to another. The deed must contain the names of the previous owner and the new owner, as well as a legally acceptable description of the property being transferred. A lease is an agreement by which the right to use real property is temporarily transferred from its owner, the landlord, to a tenant. In return for use of the property, the tenant generally pays rent on a weekly, monthly, or yearly basis. A lease is granted for a specific period of time, after which a new lease may be negotiated. If the lease is terminated, the right to use the real property reverts to the landlord.

Transfer of ownership for personal property depends on how payment is made. When the buyer pays the **full cash price** at the time of purchase, the title to personal property passes to the buyer immediately. When the buyer purchases goods on an **installation plan**, the title passes to the buyer when he or she takes possession of the goods. Although the full cash price has not been paid, the buyer has made a legally enforceable promise to pay it. This is sufficient consideration for the transfer of ownership. Moreover, if the purchased goods are stolen from the buyer, the buyer still must pay the full purchase price.

**Deed** a written document by which the ownership of real property is transferred from one person or organization to another

**Lease** an agreement by which the right to use real estate, equipment, or other assets is temporarily transferred from its owner to the user

**Negotiable instrument** a written document that (1) is a promise to pay a stated sum of money and (2) can be transferred from one person or firm to another
a negotiable instrument is a substitute for money. Checks are the most familiar form of negotiable instruments. However, promissory notes, drafts, certificates of deposit, and commercial paper are also negotiable. Even a warehouse receipt can qualify as a negotiable instrument if certain conditions are met.

Requirements for Negotiability The UCC establishes the following conditions for negotiability:

- The credit instrument must be in writing and signed.
- The instrument must contain an unconditional promise or order to pay a stated sum of money.
- The instrument must be payable on demand or at a definite future date.
- The instrument must be payable to a specified person or firm or to the bearer.

A financial document that does not meet all these requirements is not negotiable. It may still be valid and legally enforceable, but it cannot be transferred to another business or individual.

Endorsements To transfer a negotiable instrument, the payee (the person named on the face of the document) must sign it on the back. The payee's signature on the back of a negotiable instrument is called an endorsement. There are three types of endorsements, as shown at the bottom of Figure C.3.

A blank endorsement consists only of the payee's signature. It is quick, easy, and dangerous because it makes the instrument payable to anyone who gets possession of it—legally or otherwise. A restrictive endorsement states the purpose for which the instrument is to be used. For example, the words for deposit only mean that this check must be deposited in the specified account.

A special endorsement identifies the person or firm to whom the instrument is payable. The words Pay to the order of Robert Jones mean that the only person who can cash, deposit, or negotiate this check is Robert Jones.
Agency Law

An agency is a business relationship in which one party, called the principal, appoints a second party, called the agent, to act on its behalf. Most agents are independent business people or firms and are paid for their services with either set fees or commissions. They are hired to use their special knowledge for a specific purpose. For example, real estate agents are hired to sell or buy real property, insurance agents are hired to sell insurance, and theatrical agents are hired to obtain engagements for entertainers. The officers of a corporation, lawyers, accountants, and stockbrokers also act as agents.

Almost any legal activity that can be accomplished by an individual also can be accomplished through an agent. (The exceptions are voting, giving sworn testimony in court, and making a will.) Moreover, under the law, the principal is bound by the actions of the agent. However, the principal may sue an agent who performs an unauthorized act and may collect damages. For this reason, a written contract describing the conditions and limits of the agency relationship is extremely important to both parties.

A power of attorney is a legal document that serves as evidence that an agent has been appointed to act on behalf of a principal. In most states in the United States, a power of attorney is required in agency relationships involving the transfer of real estate, as well as in other specific situations.

An agent is responsible for carrying out the principal's instructions in a professional manner, for acting reasonably and with good judgment, and for keeping the principal informed of progress according to their agreement. The agent also must be careful to avoid a conflict involving the interests of two or more principals. The agency relationship is terminated when its objective is accomplished, at the end of a specified time period, or in some cases when either party renounces the agency relationship.

Bankruptcy Law

Bankruptcy is a legal procedure designed both to protect an individual or business that cannot meet its financial obligations and to protect the creditors involved. The Bankruptcy Reform Act was enacted in 1978 and was amended subsequently in July 1984 and October 2005. Under the act, bankruptcy proceedings may be initiated by either the person or the business in financial difficulty or by the creditors.

Initiating Bankruptcy Proceedings

Voluntary bankruptcy is a bankruptcy procedure initiated by an individual or business that can no longer meet its financial obligations. Individuals, partnerships, and most corporations may file for voluntary bankruptcy. Involuntary bankruptcy is a bankruptcy procedure initiated by creditors. The creditors must be able to prove that the individual or business has debts in excess of $10,000 and cannot pay its debts as they come due.

Today, most bankruptcies are voluntary. Creditors are wary of initiating bankruptcy proceedings because they usually end up losing most of the money they are owed. They usually prefer to wait and to hope that the debtor eventually will be able to pay.

Resolving a Bankruptcy Case

A petition for bankruptcy is filed in a bankruptcy court. If the court declares the individual or business bankrupt, three means of resolution are available: liquidation, reorganization, and repayment.

Chapter 7 of the Bankruptcy Reform Act concerns liquidation, the sale of assets of a bankrupt individual or business to pay its debts (see Figure C.4). In principle, the assets of the individual or business are sold to satisfy the claims of creditors. The debtor is then relieved of all remaining debts. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made it more difficult for individuals to file a Chapter 7 bankruptcy and forces them into a Chapter 13 repayment plan discussed in this section.
Chapter 11 of the Bankruptcy Reform Act outlines the procedure for reorganizing a bankrupt business. The idea is simple. The distressed business will be preserved by correcting or eliminating the factors that got the firm into financial trouble. To implement this idea, a plan to reorganize the business is developed. Only a debtor may file a reorganization plan for the first 120 days, unless a trustee has been appointed by the court. After 120 days, any interested party may file a reorganization plan. After the plan has been filed with the court, both the plan and a written disclosure statement are distributed to all individuals and businesses with claims against the bankrupt firm. These people and firms may testify at a hearing held for the purpose of confirming the plan. If the plan is confirmed by the court, the reorganized business emerges from bankruptcy with only the financial obligations imposed on it by the plan. This is exactly what occurred when United Air Lines, Federated Department Stores, U.S. Air, and Texaco filed for protection under Chapter 11.

Chapter 13 of the Bankruptcy Reform Act permits a bankrupt individual to file, with the courts, a plan for repaying specific debts. (Only individuals with a regular income, less than $307,675 in unsecured debts, and less than $922,975 in secured debts are eligible to file for repayment under Chapter 13.) The plan must provide for the repayment of specified amounts in up to three years. (In unusual circumstances, the court may extend the repayment period to five years.) If the plan is approved by the court, the individual usually pays the money to a court-appointed trustee in monthly installments. The trustee, in turn, pays the individual’s creditors.

**Government Regulation of Business**

Government helps to ensure that there is an even playing field for businesses and consumers. In this section we examine laws designed to promote competition and other areas of regulation in which government oversight is needed to reduce or eliminate abuses.

**Federal Regulations to Encourage Competition**

Most states have laws to encourage competition, but for the most part these laws duplicate federal laws. Therefore, we discuss only federal legislation designed to encourage competition. Federal laws protect consumers by ensuring that they have a choice in the marketplace. The same laws protect businesses by ensuring that they are free to compete.

The need for such laws became apparent in the late 1800s, when trusts, or monopolies, developed in the sugar, whiskey, tobacco, shoe, and oil industries, among others. A trust is created when one firm gains control of an entire industry and can set prices and manipulate trade to suit its own interests.

One of the most successful trusts was the Standard Oil Trust, created by John D. Rockefeller in 1882. Until 1911, the Standard Oil Trust controlled between 80 and 90 percent of the petroleum industry. The firm earned extremely high profits primarily...
because it had obtained secret price concessions from the railroads that shipped its products. Very low shipping costs, in turn, enabled the firm systematically to eliminate most of its competition by deliberately holding prices down. Once this was accomplished, Standard Oil quickly raised its prices.

In response to public outcry against such practices—and high prices—Congress passed the Sherman Antitrust Act in 1890. Since then, Congress has enacted a number of other laws designed to protect American businesses and consumers from monopolies.

**The Sherman Antitrust Act (1890)** The objectives of the Sherman Antitrust Act are to encourage competition and to prevent monopolies. The act specifically prohibits any contract or agreement entered into for the purpose of restraining trade. Specific business practices prohibited by the Sherman Antitrust Act include price fixing, allocation of markets among competitors, and boycotts in restraint of trade. **Price fixing** is an agreement between two businesses about the prices to be charged for goods. **Market allocation** is an agreement to divide a market among potential competitors. **Boycott in restraint of trade** is an agreement between businesses not to sell to or buy from a particular entity. Power to enforce the Sherman Antitrust Act was given to the Department of Justice.

Today the Sherman Act is still the cornerstone of the federal government’s commitment to encourage competition and to break up large businesses that monopolize trade. An amendment to the Sherman Antitrust Act, the Antitrust Procedures and Penalties Act of 1974, made violation of the Sherman Act a felony rather than a misdemeanor. It provides for fines of up to $100,000 and prison terms of up to three years for individuals convicted of antitrust violations. The act also provides that a guilty corporation may be fined up to $1 million and may be sued by competitors or customers for treble monetary damages plus attorneys’ fees.

**The Clayton Act (1914)** Because the wording of the Sherman Antitrust Act is somewhat vague, it could not be used to halt specific monopolistic tactics. Congress therefore enacted the **Clayton Act** in 1914. This legislation identifies and prohibits five distinct practices that had been used to weaken trade competition:

- **Price discrimination**—The practice in which producers and wholesalers charge larger firms a lower price for goods than they charge smaller firms. The Clayton Act does, however, allow quantity discounts.
- **Tying agreement**—A contract that forces an intermediary to purchase unwanted products along with the products it actually wants to buy. This practice was used to “move” a producer’s slow-selling merchandise along with its more desirable merchandise.
- **Binding contract**—An agreement that requires an intermediary to purchase products from a particular supplier, not from the supplier’s competitors. In return for signing a binding contract, the intermediary was generally given a price discount.
- **Interlocking directorate**—An arrangement in which members of the board of directors of one firm are also directors of a competing firm. Thus, for example, a person may not sit on the board of American Airlines and Delta Air Lines at the same time.
- **Community of interests**—A situation in which one firm buys the stock of a competing firm. If this type of merger substantially lessens competition or tends to create a monopoly, it is unlawful.

**The Federal Trade Commission Act (1914)** In 1914, Congress also passed the Federal Trade Commission Act, which states, “Unfair methods of competition in commerce are hereby declared unlawful.” This act also created the **Federal Trade Commission (FTC)**, a five-member committee charged with the responsibility of investigating illegal trade practices and enforcing antitrust laws.

At first, the FTC was limited to enforcement of the Sherman Antitrust, Clayton, and FTC Acts. However, in the 1938 Wheeler-Lea Amendment to the FTC Act, price fixing an agreement between two businesses about the prices to be charged for goods market allocation an agreement to divide a market among potential competitors boycott in restraint of trade an agreement between businesses not to sell or buy from a particular entity price discrimination the practice in which producers and wholesalers charge larger firms a lower price for goods than they charge smaller firms tying agreement a contract that forces an intermediary to purchase unwanted products along with the products it actually wants to buy binding contract an agreement that requires an intermediary to purchase products from a particular supplier, not from the supplier’s competitors interlocking directorate an arrangement in which members of the board of directors of one firm are also directors of a competing firm community of interests a situation in which one firm buys the stock of a competing firm to reduce competition between the two.
Congress gave the FTC the power to eliminate deceptive business practices—including those aimed at consumers rather than competitors. This early “consumer legislation” empowered the FTC to deal with a variety of unfair business tactics without having to prove that they endangered competition.

The Robinson-Patman Act (1936) Although the Clayton Act prohibits price discrimination, it does permit quantity discounts. This provision turned out to be a major loophole in the law. It was used by large chain retailers to obtain sizable price concessions that gave them a strong competitive edge over independent stores. To correct this imbalance, Congress passed the Robinson-Patman Act in 1936. This law specifically prohibits

- Price differentials that “substantially” weaken competition, unless they can be justified by the actual lower selling costs associated with larger orders
- Advertising and promotional allowances, unless they are offered to small retailers as well as large retailers

The Robinson-Patman Act is more controversial than most antitrust legislation. Many economists believe the act tends to discourage price competition rather than to eliminate monopolies.

The Celler-Kefauver Act (1950) The Clayton Act prohibited building a trust by purchasing the stock of competing firms. To get around that prohibition, however, a firm could still purchase the assets of its competitors. The result was the same: the elimination of competition. This gigantic loophole was closed by the Celler-Kefauver Act, which prohibits mergers through the purchase of assets if these mergers will tend to reduce competition. The act also requires all proposed mergers to be approved by both the FTC and the Justice Department.

The Antitrust Improvements Act (1976) In 1976, Congress passed the Antitrust Improvements Act to strengthen previous legislation. This law provided additional time for the FTC and the Justice Department to evaluate proposed mergers, and it expanded the investigative powers of the Justice Department. It also authorized the attorneys general of individual states to prosecute firms accused of price fixing and to recover monetary damages for consumers.

The Present Antitrust Environment The problem with antitrust legislation and its enforcement is that it is hard to define exactly what an appropriate level of competition is. For example, a particular merger may be in the public interest because it increases the efficiency of an industry. At the same time, however, it may be harmful because it reduces competition. There is really no rule of law (or of economics) that can be used to determine which of these two considerations is more important in a given case.

Three factors tend to influence the enforcement and effectiveness of antitrust legislation at the present time. The first is the growing presence of foreign firms in American markets. Foreign firms have increased competition in America and thus have made it more difficult for any firm to monopolize an industry. Second, most antitrust legislation must be interpreted by the courts because the laws are often vague and open-ended. Thus the attitude of the courts has a lot to do with the effectiveness of these laws. And third, political considerations often determine how actively the FTC and the Justice Department pursue antitrust cases.

Other Areas of Regulation

It is impossible to manage even a small business without being affected by local, state, and federal regulations. And it is just as impossible to describe all the government regulations that affect business. In addition to the regulations that affect competition just discussed, we have examined a variety of regulations in this text. Chapter 2 discussed...
laws and regulations dealing with the environment, consumerism, and discrimination; Chapter 3, international trade; Chapter 5, organization of business entities; Chapter 10, human resources and employee relations; Chapter 12 union-management relations; and Chapter 21, securities.

By now you may think that there must be a government regulation to govern any possible situation. Actually, government regulations increased from the 1930s through the 1970s, but the country then entered a deregulation period that lasted over twenty years. Today the deregulation drive continues, but there is a question as to how far it should go. Many experts now suggest that any evaluation of government regulations should determine which regulations make sense, which should be modified, and which should be eliminated. Above all, they believe, any reworking of the regulatory environment should create a “livable” environment for consumers, workers, and businesses. We look at the current status of the deregulation movement in the next section.

The Deregulation Movement

Deregulation is the process of removing existing government regulations, forgoing proposed regulations, or reducing the rate at which new regulations are enacted. The primary aim of the deregulation movement is to minimize the complexity of regulations that affect business and the cost of compliance.

Today many Americans believe that the federal government is out of control and out of touch with the needs of average citizens. These same people often complain that the federal government has too many employees and spends too much money. At the time of this publication, the U.S. government

- Employed over 2.73 million civilian workers (in addition to over 1 million military personnel).
- Spent more than $2.56 trillion a year, which is over $6,600 for every person in the United States.

Critics also complain that too many government agencies regulate business activities. More than one hundred federal agencies are currently responsible for enforcing a staggering array of regulations. And at least fifteen federal agencies now have a direct impact on business firms. These agencies and the activities they regulate are listed in Table C.1.

Advocates of deregulation are quick to point out that every business—both large and small—must obey a large number of government restrictions and directives and that doing so is costly. Large corporations can cope with government regulation. They have been doing so for some time. In essence, coping means passing the cost of regulation along to stockholders in the form of lower dividends and to consumers in the form of higher prices. Smaller firms bear a smaller regulatory burden, but they may find it harder to cope with that burden. Some may not have the staff necessary to comply with the various documentation requirements. And for many small businesses, stiff competition for customers requires that they pass the cost of compliance directly to their owners.

In every presidential election since the 1970s, the candidates elected to office were sincere when they promised the American people that they were prepared to declare war on the bureaucracy in Washington and cut unnecessary government spending from the federal budget. Presidents Nixon, Carter, Reagan, Bush, Clinton, and George W. Bush all had their own ideas on how government should be reorganized. But each president found that government reform is often stymied by overwhelming red tape in federal regulations, duplication of services, rigid civil service rules, and opposition from senators and representatives who seek to protect their favorite agencies or “pork barrel.” Each president found that decades of growth and power in government cannot be swept away overnight.
Government Taxation

Whether you believe that there is too much government or too little, you are required to help pay for it. In one way or another, each of us pays for everything government does—from regulating business to funding research into the causes and cures of cancer. We pay taxes to our local, state, and federal governments on the basis of what we earn, what we own, and even what we purchase.

Federal Taxes

It takes a lot of money to run something as big as the U.S. government. Each year vast sums are spent for human services, national defense, and interest on the national debt. In addition, the federal government must pay the salaries of its employees, cover its operating expenses, and purchase equipment and supplies that range from typewriter ribbons to aircraft carriers. Most of the money comes from taxes. In 2005, the federal government had revenues of nearly $2.1 trillion. About 95 percent of that sum was obtained through taxation. By 2010, revenues are projected to be just over $2.8 trillion, with just over 95 percent coming from taxation.

Individual Income Taxes

An individual's income tax liability is computed from his or her taxable income, which is gross income less various authorized deductions from income. In 1914, the federal government collected an average of 28 cents per taxpayer. Today that average is more than $2,200 per person.

The federal income tax is a progressive tax. A **progressive tax** requires the payment of an increasing proportion of income as the individual's income increases. For example, a single individual with a taxable income of $20,000 must currently pay a
federal income tax of $2,623, or about 13 percent of that taxable income. A single taxpayer with a taxable income of $40,000 must pay $6,560, or about 16 percent of that income.

Taxpayers must file an annual tax return by April 15 of each year for the previous calendar year. The return shows the income, deductions, and computations on which the taxpayer's tax liability is based. As shown in Figure C.5, individual income taxes provide nearly half the total federal revenues.

Corporate Income Taxes

Corporate income taxes provide approximately 7 percent of total federal revenues. Corporations pay federal income tax only on their taxable income, which is what remains after deducting all legal business expenses from net sales. Currently, the federal corporate tax rate is

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
</tr>
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<tbody>
<tr>
<td>Not over $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>$7,500 + 25% of excess over $50,000</td>
</tr>
<tr>
<td>$75,000 but not over $100,000</td>
<td>$13,750 + 34% of excess over $75,000</td>
</tr>
<tr>
<td>$100,000 but not over $330,000</td>
<td>$22,250 + 39% of excess over $100,000</td>
</tr>
<tr>
<td>$330,000 but not over $10,000,000</td>
<td>$113,900 + 34% of excess over $330,000</td>
</tr>
<tr>
<td>$10,000,000 but not over $15,000,000</td>
<td>$3,400,000 + 35% of excess over $10,000,000</td>
</tr>
<tr>
<td>$15,000,000 but not over $18,333,333</td>
<td>$5,150,000 + 38% of excess over $15,000,000</td>
</tr>
<tr>
<td>$18,333,333 and over</td>
<td>35%</td>
</tr>
</tbody>
</table>

As Table C.2 shows, a corporation with a taxable income of $330,000 must pay a total of $111,950 to the federal government.

Other Federal Taxes

Additional sources of federal revenue include Social Security, unemployment, and excise taxes, as well as customs duties. An objective of all taxes is to raise money, but excise taxes and customs duties are also designed to regulate the use of specific goods and services.

As Figure C.5 shows, the second largest source of federal revenue is the Social Security tax, which is collected under the Federal Insurance Contributions Act (FICA). This tax provides funding for retirement, disability, and death benefits for contributing employees. FICA taxes are paid by both the employer and the employee. The employee's share is withheld from his or her salary by the employer and sent to the federal government with the employer's share. The Social Security tax is broken into two components: (1) old age, survivors, and disability insurance and (2) Medicare. For old age, survivors, and disability insurance, the annual tax in 2005 was 12.4 percent of the first $90,000 earned. For Medicare, the annual tax was 2.9 percent of all wages.
Under the provisions of the Federal Unemployment Tax Act (FUTA), employers must pay an unemployment tax equal to 6.2 percent of the first $7,000 of each employee's annual wages. Because employers are allowed credits against the 6.2 percent through participation in state unemployment programs, the actual unemployment rate paid by most employers is 0.9 percent. The tax is paid to the federal government to fund benefits for unemployed workers. Unlike the Social Security tax, the FUTA tax is levied only on employers.

An excise tax is a tax on the manufacture or sale of a particular domestic product. Excise taxes are used to help pay for government services directed toward the users of these products and, in some cases, to limit the use of potentially harmful products. Alcohol and tobacco products are potentially harmful to consumers. They are taxed to raise the prices of these goods and thus discourage consumption. The federal excise tax on gasoline is a source of income that can be used to build and repair highways. Although manufacturers and retailers are responsible for paying excise taxes, these taxes usually are passed on to the consumer in the form of higher retail prices.

A customs (or import) duty is a tax on a foreign product entering a country. Import duties are designed to protect specific domestic industries by raising the prices of competing imported products. They are first paid by the importer, but the added costs are passed on to consumers through higher—and less competitive—prices.

State and Local Taxes

Like the federal government, state and local governments are financed primarily through taxes. Sales taxes provide about 35 percent of state and local tax revenues. Most states and some cities also levy taxes on the incomes of individuals and businesses. Finally, many local and county governments also tax consumer sales, real estate, and some forms of personal property.

Sales Taxes Sales taxes are levied by both states and cities and are paid by the purchasers of consumer products. Retailers collect sales taxes as a specified percentage of the price of each taxed product and then forward them to the taxing authority. A sales tax is a regressive tax. A regressive tax is one that takes a greater percentage of a lower income than of a higher income. The regressiveness of the sales tax stems from the fact that lower-income households generally spend a greater proportion of their income on taxable products such as food, clothing, and other essentials. Consider the impact of a 5 percent sales tax on food items purchased by a low-income family. A family that earns $30,000 a year and spends $9,000 on food will pay sales taxes of $150, or 1.5 percent of their total earnings. By comparison, a family that earns $80,000 a year and spends $9,000 on food will pay the same amount of sales tax, but the amount represents only 0.56 percent of their total earnings. Not all states collect a sales tax on all items. In fact, many states exempt food from their sales tax.

<table>
<thead>
<tr>
<th>Table C.2 Federal Corporate Income Tax on an Income of $330,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>According to the tax rate table, the tax is $22,250 + 39% of the excess over $100,000.</td>
</tr>
<tr>
<td>Step 1 Determine the excess over $100,000.</td>
</tr>
<tr>
<td>$330,000 - $100,000 = $230,000</td>
</tr>
<tr>
<td>Step 2 Multiply the excess amount (step 1) by the tax rate (39%).</td>
</tr>
<tr>
<td>$230,000 × 0.39 = $89,700</td>
</tr>
<tr>
<td>Step 3 To determine the total tax, add the base amount to the additional tax determined in step 2.</td>
</tr>
<tr>
<td>$ 22,250 + 89,700 = $111,950</td>
</tr>
</tbody>
</table>
Property Taxes  Many local governments rely on the property taxes they levy on real estate and personal property owned by businesses and individuals to finance their ongoing activities. Real estate taxes usually are computed as a percentage of the assessed value of the real property. (The assessed value is determined by the local tax assessor as the fair market value of the property, a portion of its fair market value, or its replacement cost.) For example, suppose that the city council has established a real estate tax rate of $2.10 per $100 of assessed valuation. Then the property tax bill for an office building with an assessed value of $200,000 will be $4,200 ($200,000 × $2.10 ÷ $100 = $4,200). This type of tax is called a proportional tax. A proportional tax is one whose percentage rate remains constant as the tax base increases. Therefore, if the tax rate remains constant at $2.10 per $100, a taxpayer who owns real estate valued at $10,000 pays $210 in taxes; a taxpayer who owns real estate valued at $100,000 pays $2,100 in taxes.

Certain personal property owned by businesses and individuals is also subject to local taxation. For businesses, taxable personal property normally includes machinery, equipment, raw materials, and finished inventory. In some cases local authorities also tax the value of stocks, bonds, mortgages, and promissory notes held by businesses. For individuals, such items as trucks, automobiles, and boats may be classified as personal property and taxed by local authorities.