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6-5-1985

## Economics of Home-Based Businesses

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### Recommended Citation

Dobbs, Thomas L., "Economics of Home-Based Businesses" (1985). *Economics Commentator*. Paper 219.  
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No. 223

June 5, 1985



## ECONOMICS OF HOME-BASED BUSINESSES

by  
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Farm and town families across South Dakota are seeking ways to supplement their income. The squeeze on agricultural incomes and on profits of rural businesses has heightened interest in home-based businesses. Home-based businesses--operated or headquartered in the home--include custom sewing, food catering, child care, "house sitting", house cleaning, "bed-and-breakfast" establishments, telephone installation and repair, and numerous other areas of activity. Such businesses are being considered not only for supplemental income, but in some cases also as possible alternatives for the principal family income source.

Over the past year and a half, SDSU's Cooperative Extension Service has conducted workshops across South Dakota on economic, organizational, legal, and technical considerations for establishing and operating home-based businesses. A brief treatment of the economic considerations presented in those workshops is contained in this Newsletter. Included are four economic steps which you should work through if you are someone trying to decide whether or not to start a home business or if you are trying to make your existing home business more profitable.

### Estimate costs

The first step is to identify and estimate your expected costs. Costs should be separated into fixed and variable categories. Fixed, or overhead, costs are those which must be incurred in order to start and remain in business, regardless of sales volume. Examples would be expenditures for remodeling part of the home for work space, for a used vehicle for deliveries, or for special tools or equipment. Variable, or operating,

costs are those which, literally, vary with the level of production and sales in your business. Expenditures for materials, vehicle fuel, and at least some kinds of labor are examples of variable costs. To get a preliminary idea of the economic feasibility of your home business idea, you can use these fixed and variable cost estimates, together with a "guesstimated" sales price, to determine the break-even level of production for the good or service; this is the minimum amount of the good or service you would need to sell, at that price, to at least not lose money.

### Examine the market

The second economic step is to examine the nature and potential size of your market. A great deal can be learned about the market through use of already available data and through systematic questioning and observation. Population data available through SDSU, for example, can give one a good idea of the potential customer numbers within a town, county, or multi-county area. Travel to nearby towns or states where the good or service you are thinking about is already sold can enable you to observe and ask questions about the income, tastes, and other characteristics of potential customers. You will also want to identify existing or potential sources of competition and to determine markets that are unserved or "underserved". In some cases, surveys of potential customers may be in order. Then, you need to piece together the information you have gathered on size of the market and competition in this market to determine the number of customers and related sales you might realistically expect to capture.

### Pricing

Examinations of costs and of the market provide bases for the third economic step, which is to determine possible prices for the good or service associated with your home-based business. Prices should be within a range that your targeted customers are likely to be willing and able to pay, competitive with other establishments or persons serving the same market, and

More than economics is involved in home-based business decisions and management. Presentors in SDSU Extension workshops on home-based businesses have discussed entrepreneurial characteristics of individuals, family considerations, and other factors that can constitute advantages or disadvantages of home-based businesses. Other considerations and analytical aids related to economics have also been covered in workshops; these include financing, cash flow analysis, balance sheets, and business records. For copies of economic examples, formulas, and forms, send a request for "Small Business Economics Handout for Workshops on Your Home Business" to the author of this Newsletter, and enclose a check (made out to the SDSU Economics Department) for \$1.50 to cover xeroxing and postage.

Concluding remarks

position to decide whether or not to attempt the business undertaking. If you are already operating a home business, profit and loss statements—developed in advance and at the end of each year—can give insights on ways you might need to alter the business.

Having completed the above economic steps, you are in a position to estimate profits (or losses). This is the fourth and final step. Profit and loss statements contain information on fixed and variable costs, sales income, and resulting net profit or loss. Prior to starting a home-based business, one should estimate prospective profits and losses for the first 3 to 5 years, since time is required to build up sales and to actually begin operating at a profit. You need to clearly spell out your profit and loss expectations and to critically examine how realistic those expectations are. Then you are in a

Profit estimation

sufficient to cover all of your fixed and variable costs. Often, prices established by home businesspersons do not cover all of their costs—if their own labor (or the labor of other family members) is included as a cost. Sometimes it might be better to raise your prices and risk losing a few customers, in order to obtain an adequate return for your own time, than to continue producing and selling "below cost". Several formulas are available to use as aids in determining sales prices based upon your estimated costs.

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Economics Newsletter

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