

The Environment of Business



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In Part 1 of *Business*, we begin with an examination of the world of business and how the economy affects our life. Next, we discuss ethical and social responsibility issues that affect business firms and our society. Then we explore the increasing importance of international business.

- > CHAPTER 1 Exploring the World of Business and Economics
- > CHAPTER 2 Being Ethical and Socially Responsible
- > CHAPTER 3 Exploring Global Business

Exploring the World of Business and Economics



Learning Objectives

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What you will be able to do once you complete this chapter:

- 1 Discuss what you must do to be successful in the world of business.
- 2 Define *business* and identify potential risks and rewards.
- 3 Define *economics* and describe the two types of economic systems: capitalism and command economy.
- 4 Identify the ways to measure economic performance.
- 5 Outline the four types of competition.
- 6 Summarize the factors that affect the business environment and the challenges that American businesses will encounter in the future.

How Amazon Kindles Business Success

At the dawn of the Internet age, entrepreneur Jeff Bezos founded a Web-based bookstore he named Amazon.com to suggest the immense selection of titles on his virtual shelves. His plan was to create a customer-centered company using cutting-edge technology to keep prices low and provide good service. In the course of building his business, Bezos pioneered many features that have become staples of online retailing, including personalized product recommendations, customer reviews, and free shipping with a minimum order.

Today, the once-tiny enterprise with the quirky name has become a giant corporation that rings up more than \$24 billion in annual sales worldwide. Amazon owns Zappos, the online shoe retailer known for outstanding service, and now sells everything from televisions, toys, and tools to computers, cameras, and clothing. It has also used its retailing expertise to become a virtual storefront for thousands of companies and individuals who sign up to sell goods and services on the Amazon Web site. In addition, it has used its tech expertise to offer on-demand services such as data storage and extra computing power to businesses of all sizes.

As CEO, Bezos continues to move Amazon in new directions. A few years ago, the company introduced the Kindle, an electronic handheld device that allows users to instantly download and read books and magazines when and where they please. The Kindle was innovative because it was the first e-book reader to connect wirelessly for content download without additional subscription or network fees. The initial response was so strong that Amazon struggled to meet the unexpectedly high demand.

Over time, Amazon has refined the Kindle by streamlining its design, adding features, making the product more eco-friendly, cutting the price, and expanding the catalog of content available for instant download. Despite competition from bookstore rival Barnes & Noble and electronics giant Sony, which have both launched wireless e-book readers, the Kindle remains popular with buyers in North America and beyond. Thanks to this and other entrepreneurial innovations, Amazon has kept sales growing for more than 15 years, even during the toughest of economic times. Now the challenge for Jeff Bezos is to extend that remarkable record of success and find new ways to kindle future profits.¹

Did You Know?

Amazon—the once-tiny enterprise with the quirky name—has become a giant corporation that rings up more than \$24 billion in annual sales worldwide.

Wow! What a challenging world we live in. Just for a moment, think about the economic problems listed here and how they affect not only businesses but also individuals.

- Unemployment rates hovering around 10 percent
- Reduced consumer spending
- A slowdown in the home-building industry and record home foreclosures
- A large number of troubled banks and financial institutions
- An increasing number of business failures
- Depressed stock values that reduced the value of investment and retirement accounts for most individuals

In fact, just about every person around the globe was affected in some way by the economic crisis that began in late 2007. Despite the efforts of the U.S. government and other world governments to provide the economic stimulus needed to stabilize the economy, it took nearly two years before the economy began to improve. Hopefully,

by the time you read this material, the nation's economy will be much stronger. Still, it is important to remember the old adage, "History is a great teacher." Both the nation and individuals should take a look at what went wrong to avoid making the same mistakes in the future. In addition, it helps to keep one factor in mind: Despite all the problems just described, make no mistake about it, our economic system will survive. In fact, our economy continues to adapt and change to meet the challenges of an ever-changing world and to provide opportunities for those who want to achieve success.

Our economic system provides an amazing amount of freedom that allows businesses that range in size from the small corner grocer to Amazon.com—the company profiled in the Inside Business opening case for this chapter—to adapt to changing business environments. Within certain limits, imposed mainly to ensure public safety, the owners of a business can produce any legal good or service they choose and attempt to sell it at the price they set. This system of business, in which individuals decide what to produce, how to produce it, and at what price to sell it, is called **free enterprise**. Our free-enterprise system ensures, for example, that Amazon.com can sell everything from televisions, toys, and tools to computers, cameras, and clothing. Our system gives Amazon's owners and stockholders the right to make a profit from the company's success. It gives Amazon's management the right to compete with bookstore rival Barnes & Noble and electronics giant Sony. It also gives consumers the right to choose.

In this chapter, we look briefly at what business is and how it became that way. First, we discuss what you must do to be successful in the world of business and explore some important reasons for studying business. Then we define *business*, noting how business organizations satisfy their customers' needs and earn profits. Next, we examine how capitalism and command economies answer four basic economic questions. Then our focus shifts to how the nations of the world measure economic performance and to the four types of competitive situations. Next, we look at the events that helped shape today's business system, the current business environment, and the challenges that businesses face.

1

Discuss what you must do to be successful in the world of business.

Your Future in the Changing World of Business

The key word in this heading is *changing*. When faced with both economic problems and increasing competition not only from firms in the United States but also from international firms located in other parts of the world, employees and managers began to ask the question: What do we do now? Although this is a fair question, it is difficult to answer. Certainly, for a college student taking business courses or an employee just starting a career, the question is even more difficult to answer. Yet there are still opportunities out there for people who are willing to work hard, continue to learn, and possess the ability to adapt to change. Let's begin our discussion in this section with three basic concepts.

- What do you want?
- Why do you want it?
- Write it down!

During a segment on *The Oprah Winfrey Show*, Joe Dudley, one of the world's most successful black business owners, gave the preceding advice to anyone who wanted to succeed in business. His advice can help you achieve success. What is so amazing about Dudley's success is that he started a manufacturing business in his own kitchen, with his wife and children serving as the new firm's only employees. He went on to develop his own line of more than 400 hair-care and cosmetic products sold directly to cosmetologists, barbers, and beauty schools. Today, Mr. Dudley has built a multimillion-dollar empire—one of the most successful minority-owned companies in the nation. He is not only a successful business owner but also a winner of the Horatio Alger Award—an award given to outstanding individuals who have succeeded in the face of adversity.² Although many people would say that Joe Dudley was just lucky or happened to be in the right place at the right time, the truth is that

free enterprise the system of business in which individuals are free to decide what to produce, how to produce it, and at what price to sell it

he became a success because he had a dream and worked hard to turn his dream into a reality. Today, Dudley’s vision is to see people succeed—to realize “The American Dream.” He would be the first to tell you that you have the same opportunities that he had. According to Mr. Dudley, “Success is a journey, not just a destination.”³

Whether you want to obtain part-time employment to pay college and living expenses, begin your career as a full-time employee, or start a business, you must *bring* something to the table that makes you different from the next person. Employers and our economic system are more demanding than ever before. Ask yourself: What can I do that will make employers want to pay me a salary? What skills do I have that employers need? With these two questions in mind, we begin the next section with another basic question: Why study business?

Why Study Business?

The potential benefits of higher education are enormous. To begin with, there are economic benefits. Over their lifetimes, college graduates on average earn much more than high school graduates. Although lifetime earnings are substantially higher for college graduates, so are annual income amounts (see Figure 1.1).

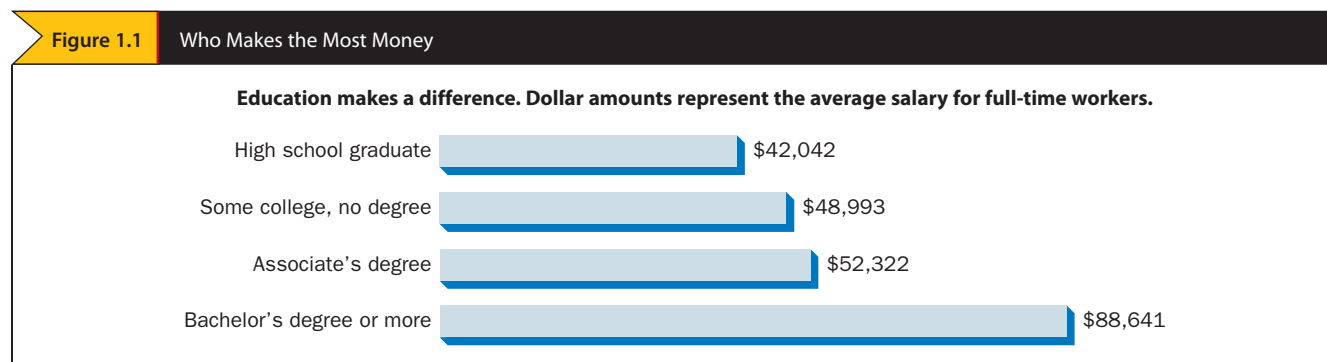
The nice feature of education and knowledge is that once you have it, no one can take it away. It is yours to use for a lifetime. In this section, we explore what you may expect to get out of this business course and text. You will find at least five compelling reasons for studying business.

For Help in Choosing a Career What do you want to do with the rest of your life? At some place and some time in your life, someone probably has asked you this same question. Like many people, you may find it a difficult question to answer. This business course will introduce you to a wide array of employment opportunities. In private enterprise, these range from small, local businesses owned by one individual to large companies such as American Express and Marriott International that are owned by thousands of stockholders. There are also employment opportunities with federal, state, county, and local governments and with not-for-profit organizations such as the Red Cross and Save the Children. For help in deciding which career might be right for you, read Appendix A: Careers in Business, which appears on the text Web site. To view this information:

1. Make an Internet connection and go to www.cengagebrain.com.
2. At the CengageBrain.com home page, search for the ISBN of your title (from the back cover of your book) using the search box at the top of the page. This will take you to the product page where free companion resources can be found.

In addition to career information in Appendix A, a number of additional Web sites provide information about career development. For more information, visit the following sites:

- Career Builder at <http://www.careerbuilder.com>
- Career One Stop at <http://www.careeronestop.org>



Source: The 2010 Statistical Abstract of the U. S. Web site at <http://www.census.gov> (accessed March 26, 2010). Salary amounts were obtained from Table 687.



Clicking Your Career into High Gear

In today's competitive business world, you should be networking online if you want to click your career into high gear. You can use Facebook, Twitter, LinkedIn, and other networking Web sites to locate job openings, help prospective employers to find you, and make a good impression on current and future bosses.

For example, David Gallant posted his résumé on job-search Web sites and followed up on leads from tech industry sources even before he graduated from the University of New Hampshire. He also set up his own blog to showcase his skills and hobbies and started conversing with other tech enthusiasts via Twitter posts. When he noticed a tweet about a job opening in his field, he applied immediately. Before interviewing Gallant, company managers checked his blog page and Twitter

posts—and they liked what they saw. Gallant's job search ended successfully: He was hired within two weeks of graduation.

How can you make the most of online networking? First, identify and join sites where you can connect with potential employers, former classmates, and others who may have, or may hear of, job openings. Second, be sure your online profiles, photographs, and posts communicate your abilities and interests without being offensive or overly revealing. Finally, be ready to click quickly when you spot a job opening.



Sources: James Limbach, "Social Networking Explodes as Job-Search Tool," *ConsumerAffairs.com*, November 23, 2009, http://www.consumeraffairs.com/news04/2009/11/social_networking_jobs.html; Sarah E. Needleman, "A New Job Just a Tweet Away," *Wall Street Journal*, September 8, 2009, <http://online.wsj.com/article/SB10001424052970204584404574393102737256542.html>; Barbara Kiviat, "Using Twitter and Facebook to Find a Job," *Time*, June 8, 2009, <http://www.time.com/time/business/article/0,8599,1903083,00.html>; Glenda Kwek, "Twitter: The New Way to Find a Job," *Sydney Morning Herald*, March 27, 2009, <http://www.smh.com.au/articles/2009/03/27/1237657117773.html>; "UNH Grad Finds a Job Using Twitter," *University of New Hampshire Information Technology Pipeline*, March 27, 2009, <http://pipeline.unh.edu/tag/twitter/>.

- Monster at <http://www.monster.com>
- Yahoo! Hot Jobs at <http://hotjobs.yahoo.com>

One thing to remember as you think about what your ideal career might be is that a person's choice of a career ultimately is just a reflection of what he or she values and holds most important. What will give one individual personal satisfaction may not satisfy another. For example, one person may dream of a career as a corporate executive and becoming a millionaire before the age of 30. Another may choose a career that has more modest monetary rewards but that provides the opportunity to help others. One person may be willing to work long hours and seek additional responsibility to get promotions and pay raises. Someone else may prefer a less demanding job with little stress and more free time. What you choose to do with your life will be based on what you feel is most important. And *you* are a very important part of that decision.

To Be a Successful Employee Deciding on the type of career you want is only the first step. To get a job in your chosen field and to be successful at it, you will have to develop a plan, or a road map, that ensures that you have the skills and knowledge the job requires. You will be expected to have both the technical skills needed to accomplish a specific task and the ability to work well with many types of people in a culturally diverse workforce. **Cultural (or workplace) diversity** refers to the differences among people in a workforce owing to race, ethnicity, and gender. These skills, together with a working knowledge of the American business system and an appreciation for a culturally diverse workplace, can give you an inside edge when you are interviewing with a prospective employer.

This course, your instructor, and all the resources available at your college or university can help you to acquire the skills and knowledge you will need for a successful career. But do not underestimate your part in making your dream a

cultural (or workplace) diversity differences among people in a workforce owing to race, ethnicity, and gender

reality. In addition to job-related skills and knowledge you need to be successful in a specific job, employers will also look for the following characteristics when hiring a new employee or promoting an existing employee:

- Honesty and integrity
- Willingness to work hard
- Dependability
- Time management skills
- Self-confidence
- Motivation
- Willingness to learn
- Communication skills
- Professionalism

The above skills and values are traits you will need to succeed in the workplace—and with work on your part you can learn and develop these traits to improve your chances of getting just the right job.

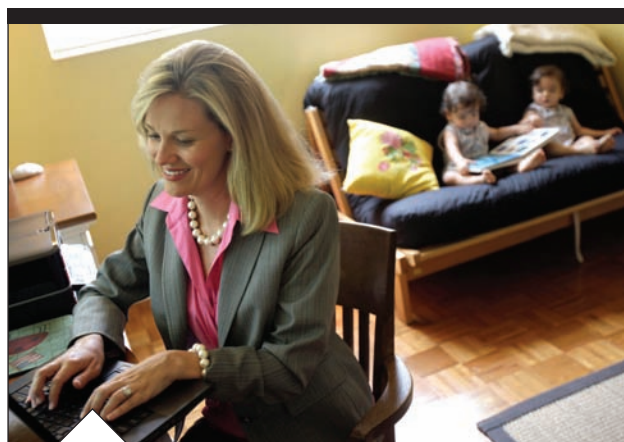
Employers will also be interested in any work experience you may have had in cooperative work/school programs, during summer vacations, or in part-time jobs during the school year. These things can make a difference when it is time to apply for the job you really want.

To Improve Your Management Skills Often, employees become managers or supervisors. In fact, many employees want to become managers because managers often receive higher salaries. Although management obviously can be a rewarding career, what is not so obvious is the amount of time and hard work needed to achieve the higher salaries. Today, managers have demanding jobs. For starters, employers expect more from managers and supervisors than ever before. Typically, the heavy workload requires that managers work long hours, and most do not get paid overtime. They also experience enormous demands on their time and face increased problems created by the economic crisis, increased competition, employee downsizing, the quest for improved quality, and the need for efficient use of the firm's resources.

To be an effective manager, managers must be able to perform four basic management functions: planning, organizing, leading and motivating, and controlling—all topics discussed in Chapter 6, Understanding the Management Process. To successfully perform these management functions, managers must possess three very important skills.

- *Interpersonal skills*—The ability to deal effectively with individual employees, other managers within the firm, and people outside the firm.
- *Technical skills*—The skill required to accomplish a specific kind of work being done in an organization. Although managers may not actually perform the technical tasks, they should be able to train employees and answer technical questions.
- *Conceptual skills*—The ability to think in abstract terms in order to see the “big picture.” Conceptual skills help managers understand how the various parts of an organization or idea can fit together.

In addition to the three skills just described, a successful manager will need many of the same skills that an employee needs to be successful. For example, oral and written communication skills, willingness to work hard, and time-management skills are important for both employees and managers.



Putting moms to work. Dixie McDaniel de Andrade used her interpersonal, technical, and conceptual skills to build a successful (and profitable) business. Her business, Mom Corps of Miami, matches moms that want to work with employers who need employees that appreciate a flexible work schedule.

To Start Your Own Business Some people prefer to work for themselves, and they open their own businesses. To be successful, business owners must possess many of the same skills that successful employees have, and they must be willing to work hard and put in long hours.

It also helps if your small business can provide a product or service that customers want. For example, Mark Cuban started a small Internet company called Broadcast.com that provided hundreds of live and on-demand audio and video programs ranging from rap music to sporting events to business events over the Internet. Because Cuban's company met the needs of his customers, Broadcast.com was very successful. When Cuban sold Broadcast.com to Yahoo! Inc., he became a billionaire.⁴

Unfortunately, many small-business firms fail; approximately 70 percent of them fail within the first seven years. Typical reasons for business failures include undercapitalization (not enough money), poor business location, poor customer service, unqualified or untrained employees, fraud, lack of a proper business plan, and failure to seek outside professional help. The material in Chapter 5 and selected topics and examples throughout this text will help you to decide whether you want to open your own business. This material will also help you to overcome many of these problems.

To Become a Better Informed Consumer and Investor The world of business surrounds us. You cannot buy a home, a new Ford Fusion Hybrid from the local Ford dealer, a Black & Decker sander at an ACE Hardware store, a pair of jeans at Gap Inc., or a hot dog from a street vendor without entering a business transaction. Because you no doubt will engage in business transactions almost every day of your life, one very good reason for studying business is to become a more fully informed consumer. Many people also rely on a basic understanding of business to help them to invest for the future. According to Julie Stav, Hispanic stockbroker-turned-author/radio personality, "Take \$25, add to it drive plus determination and then watch it multiply into an empire."⁵ The author of *Get Your Share*, a *New York Times* best seller, believes that it is important to learn the basics about the economy and business, stocks, mutual funds, and other alternatives before investing your money. She also believes that it is never too early to start investing. Although this is an obvious conclusion, just dreaming of being rich does not make it happen. In fact, like many facets of life, it takes planning and determination to establish the type of investment program that will help you to accomplish your financial goals.

Special Note to Students

It is important to begin reading this text with one thing in mind: *This business course does not have to be difficult.* We have done everything possible to eliminate the problems that students encounter in a typical class. All the features in each chapter have been evaluated and recommended by instructors with years of teaching experience. In addition, business students were asked to critique each chapter component. Based on this feedback, the text includes the following features:

- *Learning objectives* appear at the beginning of each chapter.
- *Inside Business* is a chapter-opening case that highlights how successful companies do business on a day-to-day basis.
- *Margin notes* are used throughout the text to reinforce both learning objectives and key terms.
- *Boxed features* highlight how both employees and entrepreneurs can be successful.
- *Spotlight* features highlight interesting facts about business and society and often provide a real-world example of an important concept within a chapter.
- *Sustaining the Planet* features provide information about companies working to protect the environment.

- *End-of-chapter materials* provide questions about the opening case, a chapter summary, a list of key terms, review and discussion questions, and two cases. The last section of every chapter is entitled Building Skills for Career Success and includes exercises devoted to building communication skills with a journal exercise, exploring the Internet, developing critical-thinking skills, building team skills, and researching different careers.
- *End-of-part materials* provide a continuing video case about Graeter’s Ice Cream, a company that operates a chain of retail outlets in the Cincinnati, Ohio, area and sells to more than 760 Kroger Stores throughout the country. Also, at the end of each major part is an exercise designed to help you to develop the components that are included in a typical business plan.

In addition to the text, a number of student supplements will help you to explore the world of business. We are especially proud of the Web site that accompanies this edition. There, you will find online study aids, such as key terms and definitions, crossword puzzles, interactive quizzes, student PowerPoint slides, and links to the videos for each chapter. If you want to take a look at the Internet support materials available for this edition of *Business*,

1. Make an Internet connection and go to www.cengagebrain.com.
2. At the CengageBrain.com home page, search for the ISBN of your title (from the back cover of your book) using the search box at the top of the page. This will take you to the product page where free companion resources can be found.

As authors, we want you to be successful. We know that your time is valuable and that your schedule is crowded with many different activities. We also appreciate the fact that textbooks are expensive. Therefore, we want you to use this text and get the most out of your investment. To help you get off to a good start, a number of suggestions for developing effective study skills and using this text are provided in Table 1.1. Why not take a look at these suggestions and use them to help you succeed in this course and earn a higher grade. Remember what Joe Dudley said, “Success is a journey, not just a destination.”

Because a text should always be evaluated by the students and instructors who use it, we would welcome and sincerely appreciate your comments and suggestions. Please feel free to contact us by using one of the following e-mail addresses:

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Table 1.1 Seven Ways to Use this Text and Its Resources	
1. Prepare before you go to class.	Early preparation is the key to success in many of life’s activities. Certainly, early preparation can help you to participate in class, ask questions, and improve your performance on examinations.
2. Read the chapter.	Although it may seem like an obvious suggestion, many students never take the time to really read the material. Find a quiet space where there are no distractions, and invest enough time to become a “content expert.”
3. Underline or highlight important concepts.	Make this text yours. Do not be afraid to write on the pages of your text or highlight important material. It is much easier to review material if you have identified important concepts.
4. Take notes.	While reading, take the time to jot down important points and summarize concepts in your own words. Also, take notes in class.
5. Apply the concepts.	Learning is always easier if you can apply the content to your real-life situation. Think about how you could use the material either now or in the future.
6. Practice critical thinking.	Test the material in the text. Do the concepts make sense? To build critical-thinking skills, answer the questions that accompany the cases at the end of each chapter. Also, many of the exercises in the Building Skills for Career Success require critical thinking.
7. Prepare for the examinations.	Allow enough time to review the material before the examinations. Check out the summary and review questions at the end of the chapter. Then use the resources on the text Web site.

Define *business* and identify potential risks and rewards.

Business: A Definition

Business is the organized effort of individuals to produce and sell, for a profit, the goods and services that satisfy society's needs. The general term *business* refers to all such efforts within a society (as in "American business"). However, a *business* is a particular organization, such as Kraft Foods, Inc., or Cracker Barrel Old Country Stores. To be successful, a business must perform three activities. It must be organized, it must satisfy needs, and it must earn a profit.

The Organized Effort of Individuals

For a business to be organized, it must combine four kinds of resources: material, human, financial, and informational. *Material* resources include the raw materials used in manufacturing processes as well as buildings and machinery. For example, Sara Lee Corporation needs flour, sugar, butter, eggs, and other raw materials to produce the food products it sells worldwide. In addition, this Illinois-based company needs human, financial, and informational resources. *Human* resources are the people who furnish their labor to the business in return for wages. The *financial* resource is the money required to pay employees, purchase materials, and generally keep the business operating. *Information* is the resource that tells the managers of the business how effectively the other three resources are being combined and used (see Figure 1.2).

Today, businesses are usually organized as one of three specific types. *Manufacturing businesses* process various materials into tangible goods, such as delivery trucks, towels, or computers. Intel, for example, produces computer chips that, in turn, are sold to companies that manufacture computers. *Service businesses* produce services, such as haircuts, legal advice, or tax preparation. Some firms called *marketing intermediaries* buy products from manufacturers and then resell them. Sony Corporation is a manufacturer that produces stereo equipment, among other things. These products may be sold to a marketing intermediary such as Best Buy, which then resells the manufactured goods to consumers in their retail stores.

Satisfying Needs

The ultimate objective of every firm must be to satisfy the needs of its customers. People generally do not buy goods and services simply to own them; they buy products and services to satisfy particular needs. Some of us may feel that the need for transportation is best satisfied by an air-conditioned BMW with stereo compact-disc player, automatic transmission, power seats and windows, and remote-control side mirrors. Others may believe that a Chevrolet Aveo with a stick shift will do just fine. Both products are available to those who want them, along with a wide variety of other products that satisfy the need for transportation.

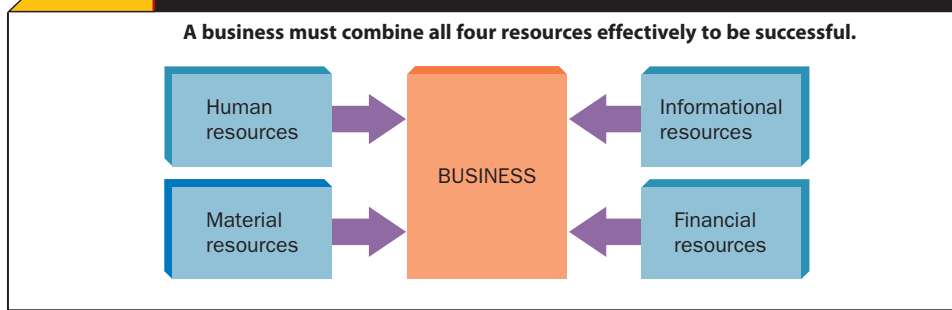
When firms lose sight of their customers' needs, they are likely to find the going rough. However, when businesses understand their customers' needs and work to satisfy those needs, they are usually successful. Back in 1962, Sam Walton opened his first discount store in Rogers, Arkansas. Although the original store was quite different from the Walmart Superstores you see today, the basic ideas of providing customer service and offering goods that satisfied needs at low prices are part of the reason why this firm has grown to become the largest retailer in the world. Although Walmart has over 8,400 retail stores in the United States and 14 other countries, this highly successful discount-store organization continues to open new stores to meet the needs of its customers around the globe.⁶

business the organized effort of individuals to produce and sell, for a profit, the products and services that satisfy society's needs



Organization at its best! While all businesses need to be organized, imagine what would happen on this construction site if this construction business weren't organized. To be successful, this business must use material, human, financial, and information resources to construct a new office building.

Figure 1.2 Combining Resources



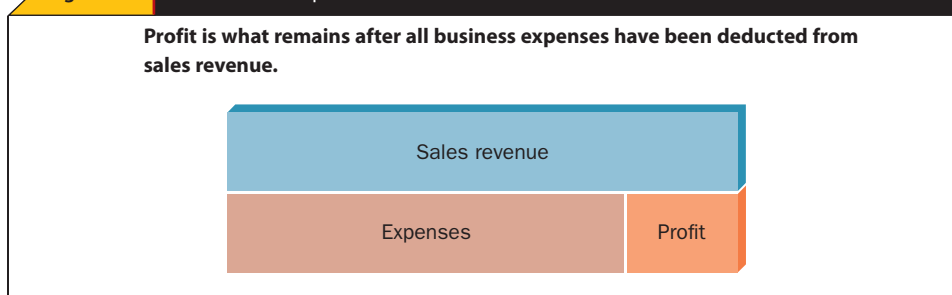
Business Profit

A business receives money (sales revenue) from its customers in exchange for goods or services. It must also pay out money to cover the expenses involved in doing business. If the firm's sales revenues are greater than its expenses, it has earned a profit. More specifically, as shown in Figure 1.3, **profit** is what remains after all business expenses have been deducted from sales revenue.

A negative profit, which results when a firm's expenses are greater than its sales revenue, is called a *loss*. A business cannot continue to operate at a loss for an indefinite period of time. Management and employees must find some way to increase sales revenues and reduce expenses to return to profitability. If some specific actions are not taken to eliminate losses, a firm may be forced to file for bankruptcy protection. In some cases, the pursuit of profits is so important that some corporate executives, including those from such corporations as Lehman Brothers, AIG, and mortgage lenders Freddie Mac and Fannie Mae, have fudged their profit figures to avoid disappointing shareholders, directors, Wall Street analysts, lenders, and other stakeholders. The term **stakeholders** is used to describe all the different people or groups of people who are affected by the policies, decisions, and activities made by an organization.

Although many people—especially stockholders and business owners—believe that profit is literally the bottom line or most important goal for a business, many stakeholders may be just as concerned about a firm's social responsibility record. Many corporations, for example, are careful to point out their efforts to sustain the planet, participate in the green ecological movement, and help people to live better lives in an annual social responsibility report. In its 57-page social responsibility report, General Mills describes how it has contributed approximately 5 percent of its pretax profits each year since 2000 to a wide variety of causes, including support for programs that feed the hungry and non-profit organizations in the United States and around the globe.⁷ Although stockholders and business owners sometimes argue that the money that a business contributes to charitable causes could have been used to pay larger dividends to stockholders or increase the return on the owners' investment, the fact is that most socially responsible business firms feel social responsibility is the right thing to do and is good for business.

Figure 1.3 The Relationship Between Sales Revenue and Profit



profit what remains after all business expenses have been deducted from sales revenue
stakeholders all the different people or groups of people who are affected by the policies and decisions made by an organization

3

Define *economics* and describe the two types of economic systems: capitalism and command economy.

economics the study of how wealth is created and distributed

microeconomics the study of the decisions made by individuals and businesses

macroeconomics the study of the national economy and the global economy

economy the way in which people deal with the creation and distribution of wealth

factors of production resources used to produce goods and services



New energy from an old source: the wind. To protect the environment, as well as to reduce our dependence on oil from foreign nations, many utility companies are developing alternative energy sources such as wind power. Once developed, wind energy may actually be cheaper than using foreign oil.

The profit earned by a business becomes the property of its owners. Thus, in one sense, profit is the reward business owners receive for producing goods and services that consumers want. Profit is also the payment that business owners receive for assuming the considerable risks of business ownership. One of these is the risk of not being paid. Everyone else—employees, suppliers, and lenders—must be paid before the owners.

A second risk that owners undertake is the risk of losing whatever they have invested into the business. A business that cannot earn a profit is very likely to fail, in which case the owners lose whatever money, effort, and time they have invested.

To satisfy society's needs and make a profit, a business must operate within the parameters of a nation's economic system. In the next section, we define economics and describe two different types of economic systems.

Types of Economic Systems

Economics is the study of how wealth is created and distributed. By *wealth*, we mean “anything of value,” including the products produced and sold by business. *How wealth is distributed* simply means “who gets what.” Experts often use economics to explain the choices we make and how these choices change as we cope with the demands of everyday life. In simple terms, individuals, businesses, governments, and society must make decisions that reflect what is important to each group at a particular time. For example, suppose you want to take a weekend trip to some exotic vacation spot, and you also want to begin an investment program. Because of your financial resources, though, you cannot do both, so you must decide what is most important. Business firms, governments, and to some extent society face the same types of decisions. Each group must deal with scarcity when making important decisions. In this case, *scarcity* means “lack of resources”—money, time, natural resources, and so on—that are needed to satisfy a want or need.

Today, experts often study economic problems from two different perspectives: microeconomics and macroeconomics. **Microeconomics** is the study of the decisions made by individuals and businesses. Microeconomics, for example, examines how the prices of homes affect the number of homes individuals will buy. On the other hand, **macroeconomics** is the study of the national economy and the global economy. Macroeconomics examines the economic effect of national income, unemployment, inflation, taxes, government spending, interest rates, and similar factors on a nation and society.

The decisions that individuals, business firms, government, and society make, and the way in which people deal with the creation and distribution of wealth determine the kind of economic system, or **economy**, that a nation has.

Over the years, the economic systems of the world have differed in essentially two ways: (1) the ownership of the factors of production and (2) how they answer four basic economic questions that direct a nation's economic activity.

Factors of production are the resources used to produce goods and services. There are four such factors:

- **Land and natural resources**—elements that can be used in the production process to make appliances, automobiles, and other products. Typical examples include crude oil, forests, minerals, land, water, and even air.
- **Labor**—the time and effort that we use to produce goods and services. It includes human resources such as managers and employees.

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Rob Kalin was trying to build a small business based on his hand-crafted furniture when a lengthy Web search sent him down a different path to entrepreneurial success. The 25-year-old New York University graduate had spent several frustrating hours clicking around the Internet to locate an online outlet for his furniture. When he found nothing suitable, he decided to create a new online marketplace, Etsy.com, where artisans, customers, and vendors could connect with each other to buy and sell handmade products such as jewelry or art, vintage items, and craft supplies.

Kalin knew enough about the Web to design the basic site, and he recruited friends and former classmates to handle technical operations. A \$50,000 investment from one of his furniture customers helped fund the fledgling firm, which opened its virtual doors in June 2005. That first year, Etsy sold \$166,000 worth of crafts. During the second year, Kalin and his

colleagues sought advice and investments from the co-founders of the photograph-sharing site Flickr. By the end of the second year, the company's merchandise sales topped \$3.8 million. Etsy was on its way.

Today, Etsy employs 70 people and rings up \$200 million in merchandise sales. Kalin sold a small percentage of the company in 2008 and, after hiring a new CEO, stepped back from day-to-day management. Two years later in 2010, Kalin took over again as CEO. He now devotes most of his time to planning for Etsy's future success.



Sources: Donna Fenn, "Meet Rob Kalin, the Man Behind Etsy.com," *Reader's Digest*, December 2009, <http://www.rd.com/your-america-inspiring-people-and-stories/meet-rob-kalin-the-man-behind-etsycom/article169446.html>; Cara S. Trager, "Crain's 2009 Top Entrepreneurs: Designer Crafts Artisan Community," *Crain's New York Business*, May 31, 2009, http://mycrains.craainsnewyork.com/small_business_awards/profiles/2009/210; Linda Tischler, "Fast Company 50 #44: Etsy," *Fast Company*, February 11, 2009, http://www.fastcompany.com/fast50_09/profile/list/etsy; <http://www.etsy.com>.

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- **Capital**—the money, facilities, equipment, and machines used in the operation of organizations. Although most people think of capital as just money, it can also be the manufacturing equipment in a Pepperidge Farm production facility or a computer used in the corporate offices of McDonald's.
- **Entrepreneurship**—the activity that organizes land, labor, and capital. It is the willingness to take risks and the knowledge and ability to use the other factors of production efficiently. An **entrepreneur** is a person who risks his or her time, effort, and money to start and operate a business.

A nation's economic system significantly affects all the economic activities of its citizens and organizations. This far-reaching impact becomes more apparent when we consider that a country's economic system determines how the factors of production are used to meet the needs of society. Today, two different economic systems exist: capitalism and command economies. The way each system answers the four basic economic questions listed here determines a nation's economy.

1. What goods and services—and how much of each—will be produced?
2. How will these goods and services be produced?
3. For whom will these goods and services be produced?
4. Who owns and who controls the major factors of production?

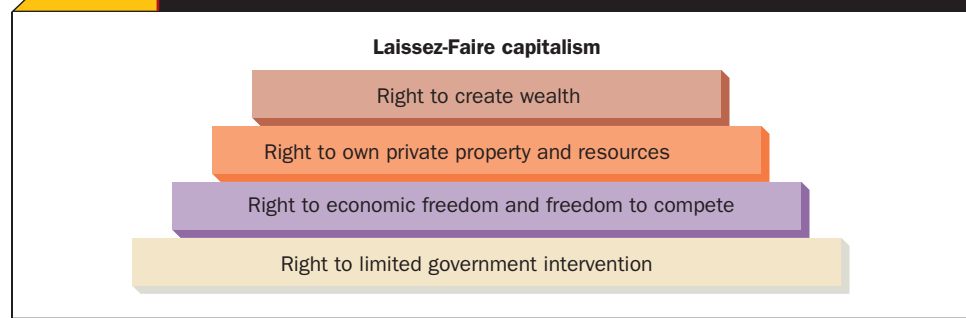
Capitalism

Capitalism is an economic system in which individuals own and operate the majority of businesses that provide goods and services. Capitalism stems from the theories of the 18th-century Scottish economist Adam Smith. In his book *Wealth of Nations*, published in 1776, Smith argued that a society's interests are best served when the individuals within that society are allowed to pursue their own self-interest. In other words, people will work hard and invest long hours to produce goods and services only if they can reap the rewards of their labor—more pay or profits in the case

entrepreneur a person who risks time, effort, and money to start and operate a business

capitalism an economic system in which individuals own and operate the majority of businesses that provide goods and services

Figure 1.4 Basic Assumptions for Adam Smith's Laissez-Faire Capitalism



of a business owner. According to Smith, when individuals act to improve their own fortunes, they indirectly promote the good of their community and the people in that community. Smith went on to call this concept the “invisible hand.” The **invisible hand** is a term created by Adam Smith to describe how an individual’s own personal gain benefits others and a nation’s economy. For example, the only way a small-business owner who produces shoes can increase personal wealth is to sell shoes to customers. To become even more prosperous, the small-business owner must hire workers to produce even more shoes. According to the invisible hand, people in the small-business owner’s community not only would have shoes but also would have jobs working for the shoemaker. Thus, the success of people in the community and, to some extent, the nation’s economy is tied indirectly to the success of the small-business owner.

Adam Smith’s capitalism is based on the four fundamental issues illustrated in Figure 1.4.

1. The creation of wealth is properly the concern of private individuals, not the government.
2. Private individuals must own private property and the resources used to create wealth.
3. Economic freedom ensures the existence of competitive markets that allow both sellers and buyers to enter and exit the market as they choose.
4. The role of government should be limited to providing defense against foreign enemies, ensuring internal order, and furnishing public works and education.

invisible hand a term created by Adam Smith to describe how an individual’s personal gain benefits others and a nation’s economy

market economy an economic system in which businesses and individuals decide what to produce and buy, and the market determines quantities sold and prices



Consumers—the biggest customer of American business.

Consumers are a very important part of our capitalistic system because families like the one pictured here purchase approximately 70 percent of the goods and services produced by American business.

One factor that Smith felt was extremely important was the role of government. He believed that government should act only as rule maker and umpire. The French term *laissez faire* describes Smith’s capitalistic system and implies that there should be no government interference in the economy. Loosely translated, this term means “let them do” (as they see fit).

Adam Smith’s Laissez-Faire capitalism is also based on the concept of a market economy. A **market economy** (sometimes referred to as a *free-market economy*) is an economic system in which businesses and individuals decide what to produce and buy, and the market determines prices and quantities sold. The owners of resources should be free to determine how these resources are used and also to enjoy the income, profits, and other benefits derived from ownership of these resources.

Capitalism in the United States

Our economic system is rooted in the Laissez-Faire capitalism of Adam Smith. However, our real-world economy is not as Laissez-Faire as Smith would have liked because

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Figure 1.5 The Circular Flow in Our Mixed Economy



government participates as more than umpire and rule maker. Our economy is, in fact, a **mixed economy**, one that exhibits elements of both capitalism and socialism.

In a mixed economy, the four basic economic questions discussed at the beginning of this section (what, how, for whom, and who) are answered through the interaction of households, businesses, and governments. The interactions among these three groups are shown in Figure 1.5.

Households Households, made up of individuals, are the consumers of goods and services as well as owners of some of the factors of production. As *resource owners*, the members of households provide businesses with labor, capital, and other resources. In return, businesses pay wages, rent, and dividends and interest, which households receive as income.

As *consumers*, household members use their income to purchase the goods and services produced by business. Today, approximately 70 percent of our nation’s total production consists of **consumer products**—goods and services purchased by individuals for personal consumption.⁸ This means that consumers, as a group, are the biggest customers of American business.

Businesses Like households, businesses are engaged in two different exchanges. They exchange money for natural resources, labor, and capital and use these resources to produce goods and services. Then they exchange their goods and services for sales revenue. This sales revenue, in turn, is exchanged for additional resources, which are used to produce and sell more goods and services. Thus, the circular flow of Figure 1.5 is continuous.

Along the way, of course, business owners would like to remove something from the circular flow in the form of profits. Households try to retain some income

mixed economy an economy that exhibits elements of both capitalism and socialism

consumer products goods and services purchased by individuals for personal consumption

as savings. But are profits and savings really removed from the flow? Usually not! When the economy is running smoothly, households are willing to invest their savings in businesses. They can do so directly by buying stocks in businesses, by purchasing shares in mutual funds that purchase stocks in businesses, or by lending money to businesses. They can also invest indirectly by placing their savings in bank accounts. Banks and other financial institutions then invest these savings as part of their normal business operations.

When business profits are distributed to business owners, these profits become household income. (Business owners are, after all, members of households.) Thus, business profits, too, are retained in the business system, and the circular flow is complete. How, then, does government fit in?

Governments The Preamble to the Constitution sets forth the responsibility of the government to protect and promote public welfare. The numerous government services are important but they (1) would either not be produced by private business firms or (2) would be produced only for those who could afford them. Typical services include national defense, police, fire protection, education, and construction of roads and highways. To pay for all these services, governments collect a variety of taxes from households (such as personal income taxes and sales taxes) and from businesses (corporate income taxes).

Figure 1.5 shows this exchange of taxes for government services. It also shows government spending of tax dollars for resources and products required to provide these services.

Actually, with government included, our circular flow looks more like a combination of several flows. In reality, it is. The important point is that together the various flows make up a single unit—a complete economic system that effectively provides answers to the basic economic questions. Simply put, the system works.

Command Economies

Before we discuss how to measure a nation's economic performance, we look quickly at another economic system called a *command economy*. A **command economy** is an economic system in which the government decides what goods and services will be produced, how they will be produced, for whom available goods and services will be produced, and who owns and controls the major factors of production. The answers to all four basic economic questions are determined, at least to some degree, through centralized government planning. Today, two types of economic systems—*socialism* and *communism*—serve as examples of command economies.

Socialism In a socialist economy, the key industries are owned and controlled by the government. Such industries usually include transportation, utilities, communications, banking, and industries producing important materials such as steel. Land, buildings, and raw materials may also be the property of the state in a socialist economy. Depending on the country, private ownership of smaller businesses is permitted to varying degrees. Usually, people may choose their own occupations, although many work in state-owned industries.

What to produce and how to produce it are determined in accordance with national goals, which are based on projected needs and the availability of resources. The distribution of goods and services—who gets what—is also controlled by the state to the extent that it controls taxes, rents, and wages. Among the professed aims of socialist countries are the equitable distribution of income, the elimination of poverty, and the distribution of social services (such as medical care) to all who need them. The disadvantages of socialism include increased taxation and loss of incentive and motivation for both individuals and business owners.

Today, many of the nations that have been labeled as socialist nations traditionally, including France, Sweden, and India, are transitioning to a free-market economy. Currently, many countries that were once thought of as communist countries are

command economy an economic system in which the government decides what goods and services will be produced, how they will be produced, for whom available goods and services will be produced, and who owns and controls the major factors of production

now often referred to as socialist countries. Examples of former communist countries often referred to as socialists (or even capitalists) include most of the nations that were formerly part of the Union of Soviet Socialist Republics, China, and Vietnam.

Communism If Adam Smith was the father of capitalism, Karl Marx was the father of communism. In his writings during the mid-19th century, Marx advocated a classless society whose citizens together owned all economic resources. All workers would then contribute to this *communist* society according to their ability and would receive benefits according to their need.

Since the breakup of the Soviet Union and economic reforms in China and most of the Eastern European countries, the best remaining examples of communism are North Korea and Cuba. Today these so-called communist economies seem to practice a strictly controlled kind of socialism. Emphasis is placed on the production of goods the government needs rather than on the products that consumers might want, so there are frequent shortages of consumer goods. Workers have little choice of jobs, but special skills or talents seem to be rewarded with special privileges.

4

Measuring Economic Performance

Today, it is hard to turn on the radio, watch the news on television, use the Internet, or read the newspaper without hearing or seeing something about the economy. Consider for just a moment the following questions:

- Are U.S. workers as productive as workers in other countries?
- Is the gross domestic product for the United States increasing or decreasing?
- What is the current balance of trade for our country?
- Why is the unemployment rate important?

The information needed to answer these questions, along with the answers to other similar questions, is easily obtainable from many sources. More important, the answers to these and other questions can be used to gauge the economic health of a nation. For individuals, the health of our nation's economy often affects the amount of interest you pay for homes, automobiles, credit card purchases, and other credit transactions. Finally, the health of the economy can also affect your ability to get a job or the financing you need to continue your education.

Identify the ways to measure economic performance.

productivity the average level of output per worker per hour

The Importance of Productivity in the Global Marketplace

One way to measure a nation's economic performance is to assess its productivity. **Productivity** is the average level of output per worker per hour. An increase in productivity results in economic growth because a larger number of goods and services are produced by a given labor force. To see how productivity affects you and the economy, consider the following three questions:

Question: How does productivity growth affect the economy?

Answer: Because of productivity growth, it now takes just 90 workers to produce what 100 workers produced in 2001.⁹ As a result, employers have reduced costs, earned more profits, and sold their products for less. Finally, productivity growth helps American business to compete more effectively with other nations in a competitive world.



Productivity can make a company more competitive in the global marketplace. The Shanghai Automotive Industry Corporation, often referred to as SAIC, is known for efficient production of some of China's best automobiles. Because increased productivity can reduce costs and increase profits, these SAIC workers used the latest technology to produce a new-entry-level car that debuted at the 2010 Beijing auto show.

Question: *How does a nation improve productivity?*

Answer: Reducing costs and enabling employees to work more efficiently are at the core of all attempts to improve productivity. For example, productivity in the United States is expected to improve dramatically as more economic activity is transferred onto the Internet, reducing costs for servicing customers and handling routine ordering functions between businesses. Other methods that can be used to increase productivity are discussed in detail in Chapter 8.

Question: *Is productivity growth always good?*

Answer: Although economists always point to increased efficiency and the ability to produce goods and services for lower costs as a positive factor, fewer workers producing more goods and services can lead to higher unemployment rates. In this case, increased productivity is good for employers but not good for unemployed workers seeking jobs in a very competitive work environment. For example, employers were reluctant to hire new employees in the midst of the recent economic crisis. Because they had been able to produce more goods and services with fewer employees, these same employers did not want to increase the firm's salary expense by hiring new employees. As a result, unemployment rates hovered at around 10 percent for much of 2009 and 2010 despite the federal government's efforts to create new jobs and reduce the number of unemployed workers.

Important Economic Indicators that Measure a Nation's Economy

In addition to productivity, a measure called *gross domestic product* can be used to measure the economic well-being of a nation. **Gross domestic product (GDP)** is the total dollar value of all goods and services produced by all people within the boundaries of a country during a one-year period. For example, the values of automobiles produced by employees in an American-owned General Motors plant and a Japanese-owned Toyota plant in the United States are both included in the GDP for the United States. The U.S. GDP was \$14.3 trillion in 2009.¹⁰ (*Note:* At the time of publication, 2009 was the last year for which complete statistics were available.)

The GDP figure facilitates comparisons between the United States and other countries because it is the standard used in international guidelines for economic accounting. It is also possible to compare the GDP for one nation over several different time periods. This comparison allows observers to determine the extent to which a nation is experiencing economic growth. For example, government experts project that GDP will grow to \$21.8 trillion by the year 2018.¹¹

To make accurate comparisons of the GDP for different years, we must adjust the dollar amounts for inflation. **Inflation** is a general rise in the level of prices. (The opposite of inflation is deflation.) **Deflation** is a general decrease in the level of prices. By using inflation-adjusted figures, we are able to measure the real GDP for a nation. In effect, it is now possible to compare the products and services produced by a nation in constant dollars—dollars that will purchase the same amount of goods and services. Figure 1.6 depicts the GDP of the United States in current dollars and the real GDP in inflation-adjusted dollars. Note that between 1990 and 2009, America's real GDP grew from \$8 trillion to \$13 trillion.¹²

In addition to GDP and real GDP, other economic measures exist that can be used to evaluate a nation's economy. Because of the recent economic crisis, one very important statistic that is in the news on a regular basis is the unemployment rate. The **unemployment rate** is the percentage of a nation's labor force unemployed at any time. According to the Bureau of Labor Statistics, when workers are unemployed, they, their families, and the country as a whole lose. Workers and their families lose wages, and the country loses the goods or services that could have been

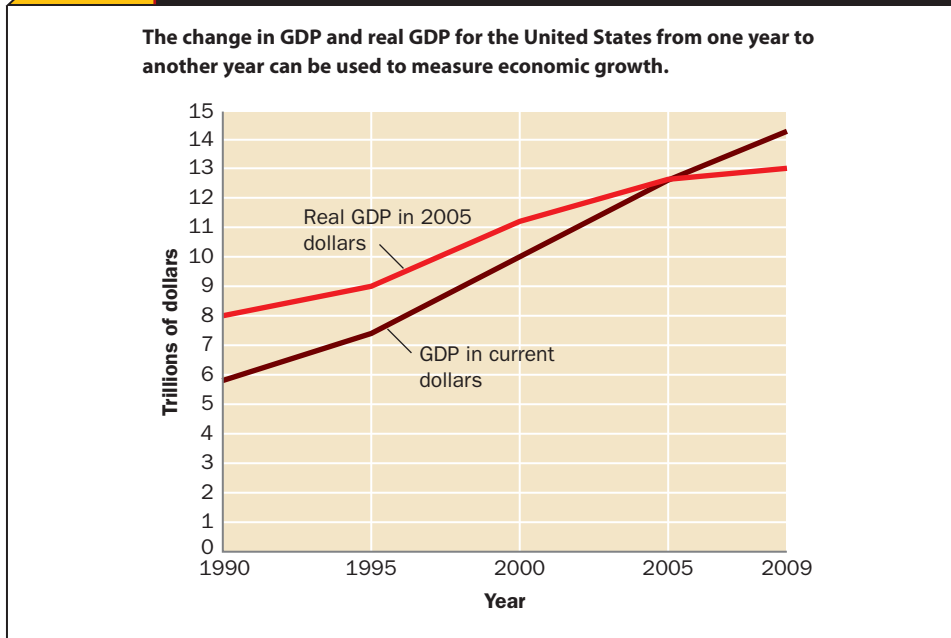
gross domestic product (GDP) the total dollar value of all goods and services produced by all people within the boundaries of a country during a one-year period

inflation a general rise in the level of prices

deflation a general decrease in the level of prices

unemployment rate the percentage of a nation's labor force unemployed at any time

Figure 1.6 GDP in Current Dollars and in Inflation-Adjusted Dollars



Source: U.S. Bureau of Economic Analysis Web site at <http://www.bea.gov> (accessed March 29, 2010).

produced. In addition, the purchasing power of these workers is lost, which can lead to unemployment for yet other workers.¹³ Despite both federal and state programs to reduce the unemployment rate for the United States, it was hovering around 10 percent at the time of publication. This is an especially important statistic—especially if you are unemployed. The **consumer price index (CPI)** is a monthly index that measures the changes in prices of a fixed basket of goods purchased by a typical consumer in an urban area. Goods listed in the CPI include food and beverages, transportation, housing, clothing, medical care, recreation, education, communication, and other goods and services. Economists often use the CPI to determine the effect of inflation on not only the nation’s economy but also individual consumers. Another monthly index is the producer price index. The **producer price index (PPI)** measures prices that producers receive for their finished goods. Because changes in the PPI reflect price increases or decreases at the wholesale level, the PPI is an accurate predictor of both changes in the CPI and prices that consumers will pay for many everyday necessities. Some additional economic measures are described in Table 1.2. Like the measures for GDP, these measures can be used to compare one economic statistic over different periods of time.

consumer price index (CPI) a monthly index that measures the changes in prices of a fixed basket of goods purchased by a typical consumer in an urban area
producer price index (PPI) an index that measures prices that producers receive for their finished goods

Table 1.2 Common Measures Used to Evaluate a Nation’s Economic Health

Economic Measure	Description
1. Balance of trade	The total value of a nation’s exports minus the total value of its imports over a specific period of time.
2. Bank credit	A statistic that measures the lending activity of commercial financial institutions.
3. Corporate profits	The total amount of profits made by corporations over selected time periods.
4. Inflation rate	An economic statistic that tracks the increase in prices of goods and services over a period of time. This measure is usually calculated on a monthly or an annual basis.
5. National income	The total income earned by various segments of the population, including employees, self-employed individuals, corporations, and other types of income.
6. New housing starts	The total number of new homes started during a specific time period.
7. Prime interest rate	The lowest interest rate that banks charge their most credit-worthy customers.



A sign of the times! Very few consumers will spend money on clothing and nonessential items if they are worried about losing their paycheck. To attract more customers during the recent economic crisis, this retailer offered a money-back guarantee—if customers lose their jobs.

The Business Cycle

All industrialized nations of the world seek economic growth, full employment, and price stability. However, a nation's economy fluctuates rather than grows at a steady pace every year. In fact, if you were to graph the economic growth rate for a country such as the United States, it would resemble a roller coaster ride with peaks (high points) and troughs (low points). These fluctuations are generally referred to as the **business cycle**, that is, the recurrence of periods of growth and recession in a nation's economic activity. At the time of publication, many experts believed that the U.S. economy was showing signs of improvement. However, the recent economic crisis that began in fall 2007 caused a recession that will require more time before the nation experiences a complete recovery. Many of the same industries that caused the recession—home construction, automobiles, banking, and finance—are still experiencing slow growth or financial problems. The nation's unemployment rate is still high. People are still frightened by the prospects of a troubled economy and are reluctant to spend money

on consumer goods. Stock values, although improving, are still below the record values experienced a few years ago. Although the federal government has enacted a number of stimulus plans designed to help unemployed workers, to shore up the nation's banks and Wall Street firms, to reduce the number of home foreclosures, and to free up credit for both individuals and businesses, many experts still believe that we have serious financial problems. For one, the size of the national debt—a topic described later in this section—is a concern. To make matters worse, the recent economic crisis did not affect just the U.S. economy but also the economies of countries around the world. Unfortunately, many of the problems that caused the recent economic crisis are still there, and they will take years to correct and resolve.

The changes that result from either economic growth or economic downturn affect the amount of products and services that consumers are willing to purchase and, as a result, the amount of products and services produced by business firms. Generally, the business cycle consists of four states: the peak (sometimes called prosperity), recession, the trough, and recovery (sometimes called expansion).

During the *peak period*, the economy is at its highest point and unemployment is low. Total income is relatively high. As long as the economic outlook remains prosperous, consumers are willing to buy products and services. In fact, businesses often expand and offer new products and services during the peak period to take advantage of consumers' increased buying power.

Generally, economists define a **recession** as two or more consecutive three-month periods of decline in a country's GDP. Because unemployment rises during a recession, total buying power declines. The pessimism that accompanies a recession often stifles both consumer and business spending. As buying power decreases, consumers tend to become more value conscious and reluctant to purchase frivolous items. In response to a recession, many businesses focus on the products and services that provide the most value to their customers. Economists define a **depression** as a severe recession that lasts longer than a typical recession. A depression is characterized by extremely high unemployment rates, low wages, reduced purchasing power, lack of confidence in the economy, lower stock values, and a general decrease in business activity.

Economists refer to the third phase of the business cycle as the *trough*. The trough of a recession or depression is the turning point when a nation's

business cycle the recurrence of periods of growth and recession in a nation's economic activity

recession two or more consecutive three-month periods of decline in a country's GDP

depression a severe recession that lasts longer than a typical recession

© Scott Olson/Getty Images

output and employment bottom out and reach their lowest levels. To offset the effects of recession and depression, the federal government uses both monetary and fiscal policies. **Monetary policies** are the Federal Reserve's decisions that determine the size of the supply of money in the nation and the level of interest rates. Through **fiscal policy**, the government can influence the amount of savings and expenditures by altering the tax structure and changing the levels of government spending.

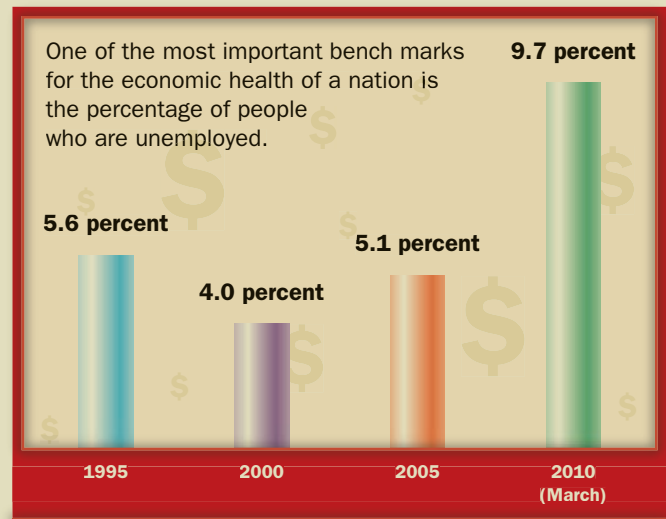
Although the federal government collects approximately \$3.0 trillion in annual revenues, the government often spends more than it receives, resulting in a **federal deficit**. For example, the government had a federal deficit for each year between 2002 and 2010. The total of all federal deficits is called the **national debt**. Today, the U.S. national debt is \$12.7 trillion or approximately \$41,000 for every man, woman, and child in the United States.¹⁴

Since World War II, business cycles have lasted from three to five years from one peak period to the next peak period. During the same time period, the average length of recessions has been 11 months.¹⁵ Some experts believe that effective use of monetary and fiscal policies can speed up recovery and reduce the amount of time the economy is in recession. *Recovery* (or *expansion*) is movement of the economy from recession or depression to prosperity. High unemployment rates decline, income increases, and both the ability and the willingness to buy rise.

At the time of publication, many business leaders and politicians were debating whether the U.S. economy is still in recession, in the trough, or beginning recovery.

SPOTLIGHT

How Many People Are Really Unemployed?



Source: The Bureau of Labor Statistics Web site at <http://www.bls.gov> (accessed April 5, 2010).

monetary policies Federal Reserve decisions that determine the size of the supply of money in the nation and the level of interest rates

Types of Competition

Our capitalist system ensures that individuals and businesses make the decisions about what to produce, how to produce it, and what price to charge for the product. Mattel, Inc., for example, can introduce new versions of its famous Barbie doll, license the Barbie name, change the doll's price and method of distribution, and attempt to produce and market Barbie in other countries or over the Internet at <http://www.mattel.com>. Our system also allows customers the right to choose between Mattel's products and those produced by competitors.

Competition like that between Mattel and other toy manufacturers is a necessary and extremely important by-product of capitalism. Business **competition** is essentially a rivalry among businesses for sales to potential customers. In a capitalistic economy, competition also ensures that a firm will survive only if it serves its customers well by providing products and services that meet needs. Economists recognize four different degrees of competition ranging from ideal, complete competition to no competition at all. These are perfect competition, monopolistic competition, oligopoly, and monopoly. For a quick overview of the different types of competition, including numbers of firms and examples for each type, look at Table 1.3.

5

Outline the four types of competition.

fiscal policy government influence on the amount of savings and expenditures; accomplished by altering the tax structure and by changing the levels of government spending

federal deficit a shortfall created when the federal government spends more in a fiscal year than it receives

national debt the total of all federal deficits

competition rivalry among businesses for sales to potential customers

Table 1.3 Four Different Types of Competition

The number of firms determines the degree of competition within an industry.		
Type of Competition	Number of Business Firms or Suppliers	Real-World Examples
1. Perfect	Many	Corn, wheat, peanuts
2. Monopolistic	Many	Clothing, shoes
3. Oligopoly	Few	Automobiles, cereals
4. Monopoly	One	Software protected by copyright, many local public utilities

Perfect Competition

Perfect (or pure) competition is the market situation in which there are many buyers and sellers of a product, and no single buyer or seller is powerful enough to affect the price of that product. Note that this definition includes several important ideas. First, we are discussing the market for a single product, such as bushels of wheat. Second, there are no restrictions on firms entering the industry. Third, all sellers offer essentially the same product for sale. Fourth, all buyers and sellers know everything there is to know about the market (including, in our example, the prices that all sellers are asking for their wheat). And fifth, the overall market is not affected by the actions of any one buyer or seller.

When perfect competition exists, every seller should ask the same price that every other seller is asking. Why? Because if one seller wanted 50 cents more per bushel of wheat than all the others, that seller would not be able to sell a single bushel. Buyers could—and would—do better by purchasing wheat from the competition. On the other hand, a firm willing to sell below the going price would sell all its wheat quickly. However, that seller would lose sales revenue (and profit) because buyers are actually willing to pay more.

In perfect competition, then, sellers—and buyers as well—must accept the going price. The price of each product is determined by the actions of all buyers and all sellers together through the forces of supply and demand.

perfect (or pure) competition the market situation in which there are many buyers and sellers of a product, and no single buyer or seller is powerful enough to affect the price of that product

supply the quantity of a product that producers are willing to sell at each of various prices

demand the quantity of a product that buyers are willing to purchase at each of various prices

market price the price at which the quantity demanded is exactly equal to the quantity supplied

The Basics of Supply and Demand The **supply** of a particular product is the quantity of the product that producers are willing to sell at each of various prices. Producers are rational people, so we would expect them to offer more of a product for sale at higher prices and to offer less of the product at lower prices, as illustrated by the supply curve in Figure 1.7.

The **demand** for a particular product is the quantity that buyers are willing to purchase at each of various prices. Buyers, too, are usually rational, so we would expect them—as a group—to buy more of a product when its price is low and to buy less of the product when its price is high, as depicted by the demand curve in Figure 1.7.

The Equilibrium, or Market, Price There is always one certain price at which the demanded quantity of a product is exactly equal to the quantity of that product produced. Suppose that producers are willing to *supply* two million bushels of wheat at a price of \$6 per bushel and that buyers are willing to *purchase* two million bushels at a price of \$6 per bushel. In other words, supply and demand are in balance, or in equilibrium, at the price of \$6. Economists call this price the *market price*. The **market price** of any product is the price at which the quantity demanded is exactly equal to the quantity supplied. If suppliers produce two million bushels, then no one who is willing to pay \$6 per bushel will have to go without

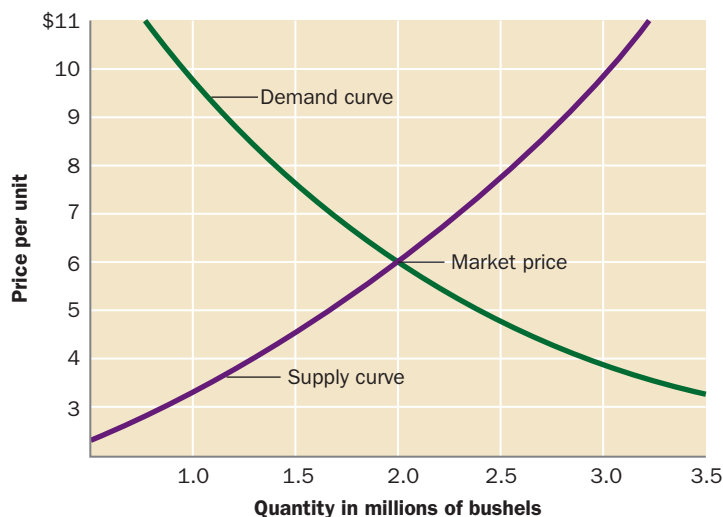


Competition often equals lower prices. In the very competitive grocery industry, retailers know that nice stores, a wide selection of grocery items, and lower prices are all factors that determine where American consumers shop for grocery items.

© AP Images/PRNewsFoto/Spartan Stores

Figure 1.7 Supply Curve and Demand Curve

The intersection of a supply curve and a demand curve is called the *equilibrium*, or *market price*. This intersection indicates a single price and quantity at which suppliers will sell products and buyers will purchase them.



wheat, and no producer who is willing to sell at \$6 per bushel will be stuck with unsold wheat.

In theory and in the real world, market prices are affected by anything that affects supply and demand. The *demand* for wheat, for example, might change if researchers suddenly discovered that it offered a previously unknown health benefit. Then buyers would demand more wheat at every price. Or the *supply* of wheat might change if new technology permitted the production of greater quantities of wheat from the same amount of acreage. Other changes that can affect competitive prices are shifts in buyer tastes, the development of new products, fluctuations in income owing to inflation or recession, or even changes in the weather that affect the production of wheat.

Perfect competition is quite rare in today's world. Many real markets, however, are examples of monopolistic competition.

Monopolistic Competition

Monopolistic competition is a market situation in which there are many buyers along with a relatively large number of sellers. The various products available in a monopolistically competitive market are very similar in nature, and they are all intended to satisfy the same need. However, each seller attempts to make its product different from the others by providing unique product features, an attention-getting brand name, unique packaging, or services such as free delivery or a lifetime warranty.

Product differentiation is the process of developing and promoting differences between one's products and all similar products. It is a fact of life for the producers of many consumer goods, from soaps to clothing to furniture to shoes. A furniture manufacturer such as Thomasville sees what looks like a mob of competitors, all trying to chip away at its share of the market. By differentiating each of its products from all similar products produced by competitors, Thomasville obtains some limited control over the market price of its product.

Oligopoly

An **oligopoly** is a market (or industry) situation in which there are few sellers. Generally, these sellers are quite large, and sizable investments are required to enter into their market. Examples of oligopolies are the automobile, airline, car rental, cereal, and farm implement industries.

monopolistic competition a market situation in which there are many buyers along with a relatively large number of sellers who differentiate their products from the products of competitors

product differentiation the process of developing and promoting differences between one's products and all similar products

oligopoly a market (or industry) in which there are few sellers

Because there are few sellers in an oligopoly, the market actions of each seller can have a strong effect on competitors' sales and prices. If General Motors, for example, reduces its automobile prices, Ford, Honda, Toyota, and Nissan usually do the same to retain their market shares. In the absence of much price competition, product differentiation becomes the major competitive weapon; this is very evident in the advertising of the major automobile manufacturers. For instance, when Toyota was faced with declining sales as a result of quality and safety issues, it began offering buyer incentives to attract new-car buyers. Quickly, both Ford and General Motors began offering similar incentives and for the same reason—to attract new-car buyers.

Monopoly

A **monopoly** is a market (or industry) with only one seller, and there are barriers to keep other firms from entering the industry. In a monopoly, there is no close substitute for the product or service. Because only one firm is the supplier of a product, it would seem that it has complete control over price. However, no firm can set its price at some astronomical figure just because there is no competition; the firm would soon find that it has no customers or sales revenue either. Instead, the firm in a monopoly position must consider the demand for its product and set the price at the most profitable level.

Classic examples of monopolies in the United States are public utilities, including companies that provide local gas, water, or electricity. Each utility firm operates in a **natural monopoly**, an industry that requires a huge investment in capital and within which any duplication of facilities would be wasteful. Natural monopolies are permitted to exist because the public interest is best served by their existence, but they operate under the scrutiny and control of various state and federal agencies. Although many public utilities are still classified as natural monopolies, there is increased competition in many industries. For example, there have been increased demands for consumer choice when selecting a company that provides electrical service to both homes and businesses.

A legal monopoly—sometimes referred to as a *limited monopoly*—is created when a government entity issues a franchise, license, copyright, patent, or trademark. For example, a copyright exists for a specific period of time and can be used to protect the owners of written materials from unauthorized use by competitors that have not shared in the time, effort, and expense required for their development. Because Microsoft owns the copyright on its popular Windows software, it enjoys a legal-monopoly position. Except for natural monopolies and legal monopolies, federal antitrust laws prohibit both monopolies and attempts to form monopolies.

6

Summarize the factors that affect the business environment and the challenges that American businesses will encounter in the future.

monopoly a market (or industry) with only one seller, and there are barriers to keep other firms from entering the industry

natural monopoly an industry requiring huge investments in capital and within which any duplication of facilities would be wasteful and thus not in the public interest

standard of living a loose, subjective measure of how well off an individual or a society is, mainly in terms of want satisfaction through goods and services

American Business Today

Although our economic system is far from perfect, it provides Americans with a high standard of living compared with people in other countries throughout the world. **Standard of living** is a loose, subjective measure of how well off an individual or a society is, mainly in terms of want satisfaction through goods and services. Also, our economic system offers solutions to many of the problems that plague society and provides opportunities for people who are willing to work and to continue learning.

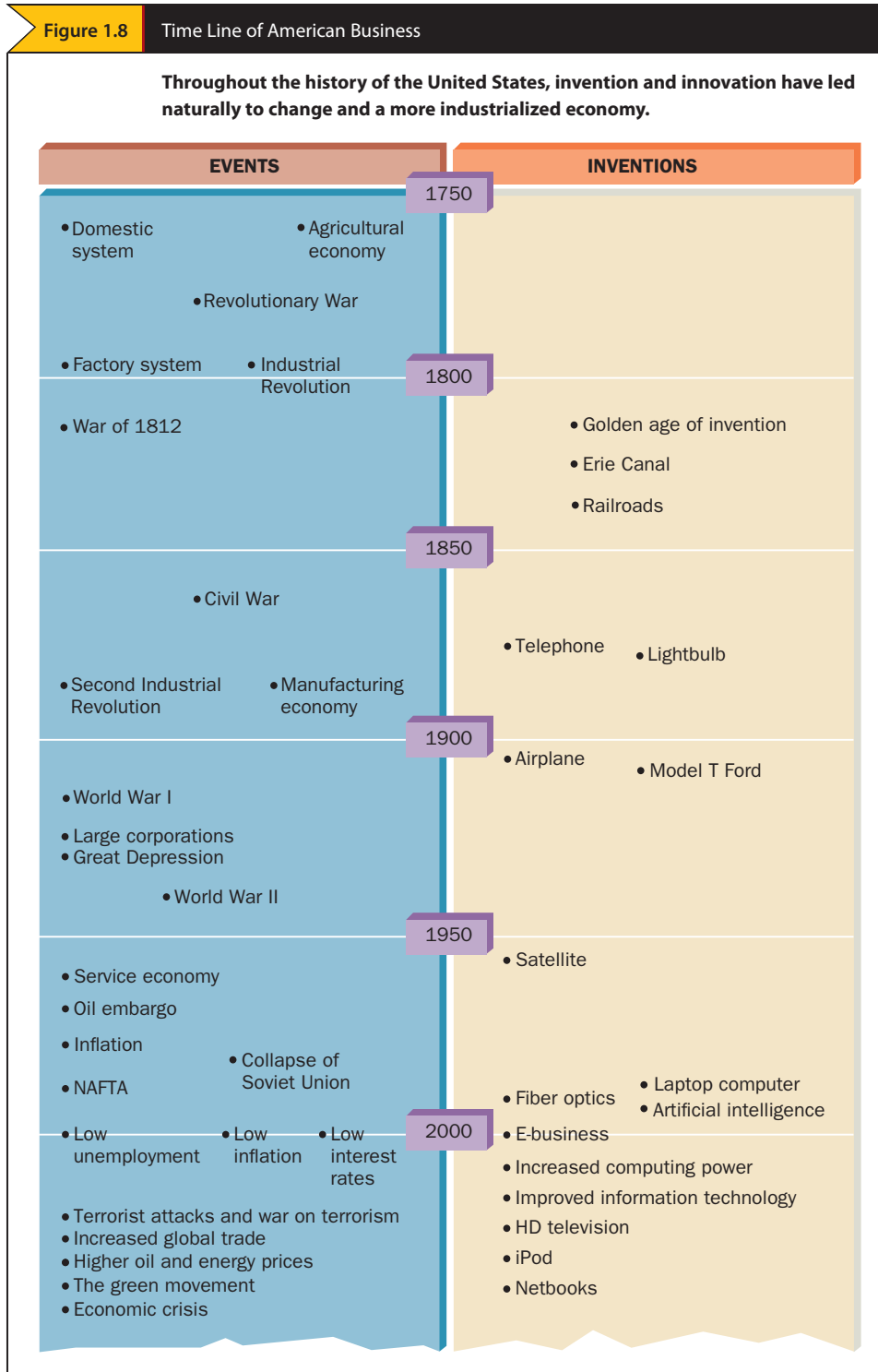
To understand the current business environment and the challenges ahead, it helps to understand how business developed.

Early Business Development

Our American business system has its roots in the knowledge, skills, and values that the earliest settlers brought to this country. Refer to Figure 1.8 for an overall view of our nation's history, the development of our business system, and some major inventions that influenced the nation and our business system.

The first settlers in the New World were concerned mainly with providing themselves with basic necessities—food, clothing, and shelter. Almost all families lived on farms, and the entire family worked at the business of surviving. They used their surplus for trading, mainly by barter, among themselves and with the English trading

Figure 1.8 Time Line of American Business



ships that called at the colonies. **Barter** is a system of exchange in which goods or services are traded directly for other goods or services without using money. As this trade increased, small-scale business enterprises began to appear. Some settlers were able to use their skills and their excess time to work under the domestic system of production. The **domestic system** was a method of manufacturing in which an entrepreneur distributed raw materials to various homes, where families would process them into finished goods. The merchant entrepreneur then offered the goods for sale.

Then, in 1789, a young English apprentice mechanic named Samuel Slater decided to sail to America. At this time, British law forbade the export of machinery,

barter a system of exchange in which goods or services are traded directly for other goods or services without using money

domestic system a method of manufacturing in which an entrepreneur distributes raw materials to various homes, where families process them into finished goods to be offered for sale by the merchant entrepreneur

technology, and skilled workers. To get around the law, Slater painstakingly memorized the plans for Richard Arkwright's water-powered spinning machine, which had revolutionized the British textile industry, and left England disguised as a farmer. A year later, he set up a textile factory in Pawtucket, Rhode Island, to spin raw cotton into thread. Slater's ingenuity resulted in America's first use of the **factory system** of manufacturing, in which all the materials, machinery, and workers required to manufacture a product are assembled in one place. The Industrial Revolution in America was born. A manufacturing technique called *specialization* was used to improve productivity. **Specialization** is the separation of a manufacturing process into distinct tasks and the assignment of the different tasks to different individuals.

The years from 1820 to 1900 were the golden age of invention and innovation in machinery. At the same time, new means of transportation greatly expanded the domestic markets for American products. Certainly, many characteristics of our modern business system took form during this time period.

Business Development in the 1900s

Industrial growth and prosperity continued well into the 20th century. Henry Ford's moving automotive assembly line, which brought the work to the worker, refined the concept of specialization and helped spur on the mass production of consumer goods. Fundamental changes occurred in business ownership and management as well. No longer were the largest businesses owned by one individual; instead, ownership was in the hands of thousands of corporate shareholders who were willing to invest in—but not to operate—a business.

The Roaring Twenties ended with the sudden crash of the stock market in 1929 and the near collapse of the economy. The Great Depression that followed in the 1930s was a time of misery and human suffering. People lost their faith in business and its ability to satisfy the needs of society without government involvement. After Franklin D. Roosevelt became president in 1933, the federal government devised a number of programs to get the economy moving again. In implementing these programs, the government got deeply involved in business for the first time.

To understand the major events that shaped the United States during the remainder of the 20th century, it helps to remember that the economy was compared to a roller coaster ride earlier in this chapter—periods of economic growth followed by periods of economic slowdown. Major events that shaped the nation's economy occurred during the period from 1940 to 2000:

- World War II, the Korean War, and the Vietnam War
- Rapid economic growth and higher standard of living during the 1950s and 1960s
- The social responsibility movement during the 1960s
- A shortage of crude oil and higher prices for most goods in the mid-1970s
- High inflation, high interest rates, and reduced business profits during the early 1980s
- Sustained economic growth in the 1990s

During the last part of the 20th century, the Internet became a major force in the economy, with computer hardware, software, and Internet service providers taking advantage of the increased need for information. e-Business—a topic we will continue to explore throughout this text—became an accepted method of conducting business. **e-Business** is the organized effort of individuals to produce and sell *through the Internet*, for a profit, the products and services that satisfy society's needs.

factory system a system of manufacturing in which all the materials, machinery, and workers required to manufacture a product are assembled in one place

specialization the separation of a manufacturing process into distinct tasks and the assignment of the different tasks to different individuals

e-business the organized effort of individuals to produce and sell *through the Internet*, for a profit, the products and services that satisfy society's needs



No one likes to wait in line. For an industrialized economy like the United States economy, crude oil is an essential natural resource. When the nation experienced a shortage of crude oil during the mid-1970s, people were forced to wait in line to buy gasoline for their cars. In addition to higher prices for gasoline and goods produced from petroleum, there was also an increase in transportation costs for finished goods.

Unfortunately, by the last part of the 20th century, a larger number of business failures and declining stock values were initial signs that larger economic problems were on the way.

A New Century: 2000 and Beyond

According to many economic experts, the time period from 2000 to 2010 might be characterized as the best of times and the worst of times rolled into one package. On the plus side, technology became available at an affordable price. Both individuals and businesses could now access information with the click of a button. They also could buy and sell merchandise online.

In addition to information technology, the growth of service businesses also changed the way American firms do business in the 21st century. Because service businesses employ approximately 85 percent of the nation's workforce, we now have a service economy.¹⁶ A **service economy** is an economy in which more effort is devoted to the production of services than to the production of goods. Typical service businesses include restaurants, laundries and dry cleaners, real estate, movie theaters, repair companies, and other services that we often take for granted. In fact, when you look at where you spend your money, there is a good chance that a great deal of cash goes to the service sector of the economy. Because of the importance of this type of business, service businesses must find ways to improve productivity and cut costs while providing jobs for an even larger portion of the workforce. More information about how service businesses affect the economy is provided in Chapter 8, Producing Quality Goods and Services.

On the negative side, it is hard to watch television, surf the Web, listen to the radio, or read the newspaper without hearing some news about the economy. Because many of the economic indicators described in Table 1.2 on page 19 indicate troubling economic problems, there is still a certain amount of pessimism surrounding the economy.

The Current Business Environment

Before reading on, answer the following question:

In today's competitive business world, which of the following environments affects business?

- a. The competitive environment
- b. The global environment
- c. The technological environment
- d. The economic environment
- e. All of the above

The correct answer is "e." All the environments listed affect business today. For example, businesses operate in a *competitive environment*. As noted earlier in this chapter, competition is a basic component of capitalism. Every day, business owners must figure out what makes their businesses successful and how their businesses are different from the competition. Often, the answer is contained in the basic definition of business provided on page 10. Just for a moment, review the definition:

Business is the organized effort of individuals to produce and sell, for a profit, the goods and services that satisfy society's needs.

Note the phrase *satisfy society's needs*. These three words say a lot about how well a successful firm competes with competitors. If you meet customer needs, then you have a better chance at success.

Related to the competitive environment is the *global environment*. Not only do American businesses have to compete with other American businesses, but they also must compete with businesses from all over the globe. According to global experts, China is the fastest-growing economy in the world. And China is not alone. Other countries around the world also compete with U.S. firms. There was once a time when the label "Made in the United States" gave U.S. businesses

service economy an economy in which more effort is devoted to the production of services than to the production of goods

How the Sun and Earth Help Frito-Lay

Frito-Lay is one of many businesses moving toward sustainability by putting the sun and Earth to work. Every day, it produces 145,000 bags of SunChips in its solar-powered Modesto, California, plant and packages the chips in eco-friendly bags that can be composted into soil instead of taking up space in landfills. Take a look: http://sunchips.com/healthier_planet.shtml.



an inside edge both at home and in the global marketplace. Now, other countries manufacture and sell goods. According to Richard Haass, president of the Council on Foreign Relations, “There will be winners and losers from globalization. We win every time we go shopping because prices are lower. Choice is greater because of globalization. But there are losers. There are people who will lose their jobs either to foreign competition or [to] technological innovation.”¹⁷

Although both increased competition and technological innovation have changed the way we do business, the *technology environment* for U.S. businesses has never been more challenging. Although many of us take technological change for granted, it does change the way we do business. Changes in manufacturing equipment, communication with customers, and distribution of products are all examples of how technology has changed everyday business practices. Technology will continue to change. New technology will require businesses to spend additional money to keep abreast of an ever-changing technology environment and even more money to train employees to use the new technology.

In addition to the competitive, global, and technology environments, the *economic environment* must always be considered when making business decisions. Although many people believe that business has unlimited resources, the truth is that managers and business owners realize that there is never enough money to fund all the activities a business might want to fund.

This fact is especially important when the nation’s economy takes a nosedive or an individual firm’s sales revenue and profits are declining. For example, both small and large business firms reduced both spending and hiring new employees over the last two years because of economic concerns related to the depressed housing, automotive, banking, and financial industries.

In addition to economic pressures, today’s socially responsible managers and business owners must be concerned about the concept of sustainability. According to the U.S. Environmental Protection Agency, **sustainability** means meeting the needs of the present without compromising the ability of future generations to meet their own needs.¹⁸ Although the word *green* used to mean a simple color in a box of crayons, today green means a new way of doing business. As a result, a combination of forces, including economic factors, growth in population, increased energy use, and concerns for the environment, is changing the way individuals live and businesses operate.

When you look back at the original question we asked at the beginning of this section, clearly, each different type of environment—competitive, global, technological, and economic—affects the way a business does *business*. As a result, there are always opportunities for improvement and challenges that must be considered.

sustainability meeting the needs of the present without compromising the ability of future generations to meet their own needs

The Challenges Ahead

There it is—the American business system in brief.

When it works well, it provides jobs for those who are willing to work, a standard of living that few countries can match, and many opportunities for personal advancement. However, like every other system devised by humans, it is not perfect. Our business system may give us prosperity, but it also gave us the Great Depression of the 1930s, the economic problems of the 1970s and the early 1980s, and the economic crisis that began in the fall of 2007.

Obviously, the system can be improved. Certainly, there are plenty of people who are willing to tell us exactly what they think the American economy needs. However, these people provide us only with conflicting opinions. Who is right and who is wrong? Even the experts cannot agree.

The experts do agree, however, that several key issues will challenge our economic system (and our nation) over the next decade. Some of the questions to be resolved include:

- How can we create a more stable economy and create new jobs for the unemployed?
- How can we regulate banks, savings and loan associations, credit unions, and other financial institutions to prevent the type of abuses that led to the banking crisis?
- How do we reduce the national debt and still maintain a healthy economy and stimulate business growth?
- How can we make American workers more productive and American firms more competitive in the global marketplace?
- How can we preserve the benefits of competition and small business in our American economic system?
- How can we encourage economic growth and at the same time continue to conserve natural resources and sustain our environment?
- How can we meet the needs of two-income families, single parents, older Americans, and the less fortunate who need health care and social programs to exist?
- How can we meet the challenges of managing culturally diverse workforces to address the needs of a culturally diverse marketplace?
- How can we defeat terrorism and resolve conflict with Iran, North Korea, and other countries throughout the world?

The answers to these questions are anything but simple. In the past, Americans have always been able to solve their economic problems through ingenuity and creativity. Now, as we continue the journey through the 21st century, we need that same ingenuity and creativity not only to solve our current problems but also to compete in the global marketplace and build a nation and economy for future generations.

According to economic experts, if we as a nation can become more competitive, we may solve many of our current economic problems. As an added bonus, increased competitiveness will also enable us to meet the social challenges we are currently facing. The way we solve these problems will affect our own future, our children's future, and that of our nation. Within the American economic and political system, the answers are ours to provide.

The American business system is not perfect by any means, but it does work reasonably well. We discuss some of its problems in Chapter 2 as we examine the topics of social responsibility and business ethics.

Amazon

When Amazon opened its virtual doors in 1995, founder Jeff Bezos had ambitious plans for building the world's biggest, best, and most customer-friendly online bookstore. The Web was still new and uncharted territory for businesses, and Amazon was breaking new ground by inviting customers to post their own book reviews and allowing them to buy with one click.

Within two years of its founding, Amazon had served millions of customers and raised millions of dollars for expansion by going public and selling corporate stock. Yet the company did not achieve profitability for several more years because Bezos was continually reinvesting in upgraded technology to enhance the customer experience and

build the business. Moving into innovative products such as the Kindle helped Amazon write a new chapter in its success story. Can the company maintain its sales and profit momentum in the coming years?

Questions

1. Of the environments that affect the business world, which have had the most significant effect on Amazon?
2. During a recent year, Amazon's earnings topped \$900 million. Why do you think this online retailer is profitable? What actions must management take to continue to earn record profits?

SUMMARY

Summary

1 Discuss what you must do to be successful in the world of business.

For many years, people in business—both employees and managers—assumed that prosperity would continue. When faced with both economic problems and increased competition, a large number of these people began to ask the question: What do we do now? Although this is a fair question, it is difficult to answer. Certainly, for a college student taking business courses or an employee just starting a career, the question is even more difficult to answer. And yet there are still opportunities out there for people who are willing to work hard, continue to learn, and possess the ability to adapt to change. To be sure, employers and our capitalistic economic system are more demanding than ever before. As you begin this course, ask yourself: What can I do that will make employers want to pay me a salary? What skills do I have that employers need? The kind of career you choose ultimately will depend on your own values and what you feel is most important in life. But deciding on the kind of career you want is only a first step. To get a job in your chosen field and to be successful at it, you will have to develop a plan, or a road map, that ensures that you have the necessary skills and the knowledge the job requires to become a better employee or manager. By studying business, you may also decide to start your own business and become a better consumer and investor.

2 Define *business* and identify potential risks and rewards.

Business is the organized effort of individuals to produce and sell, for a profit, the goods and services that satisfy society's needs. Four kinds of resources—material, human, financial, and informational—must be combined to start and operate a business. The three general types of businesses are manufacturers, service businesses, and marketing intermediaries. Profit is what remains after all business expenses are deducted from sales revenue. It is the payment that owners receive for assuming the risks of business—primarily the risks of not receiving payment and of losing whatever has been invested in the firm. Although many people believe that profit is literally the bottom line or most important goal for a business, many corporations are careful to point out their efforts to sustain the planet, participate in the green ecological movement, and help people to live better lives. The fact is that most business firms that are socially responsible feel that it is the right thing to do and is good for business.

3 Define *economics* and describe the two types of economic systems: capitalism and command economy.

Economics is the study of how wealth is created and distributed. An economic system must answer four questions: What goods and services will be produced?

How will they be produced? For whom will they be produced? Who owns and who controls the major factors of production? Capitalism (on which our economic system is based) is an economic system in which individuals own and operate the majority of businesses that provide goods and services. Capitalism stems from the theories of Adam Smith. Smith's pure Laissez-Faire capitalism is an economic system in which the factors of production are owned by private entities and all individuals are free to use their resources as they see fit; prices are determined by the workings of supply and demand in competitive markets; and the economic role of government is limited to rule maker and umpire. In his book *Wealth of Nations*, Smith argued that a society's interests are best served when the individuals within that society are allowed to pursue their own self-interest. Smith used the term *invisible hand* to describe how an individual's own personal gain benefits others and a nation's economy.

Our economic system today is a mixed economy. In the circular flow that characterizes our business system (see Figure 1.5), households and businesses exchange resources for goods and services, using money as the medium of exchange. In a similar manner, the government collects taxes from businesses and households and purchases products and resources with which to provide services.

In a command economy, government, rather than individuals, owns many of the factors of production and provides the answers to the three other economic questions. Socialist and communist economies are—at least in theory—command economies.

4 Identify the ways to measure economic performance.

One way to evaluate the performance of an economic system is to assess changes in productivity, which is the average level of output per worker per hour. Gross domestic product (GDP) can also be used to measure a nation's economic well-being and is the total dollar value of all goods and services produced by all people within the boundaries of a country during a one-year period. This figure facilitates comparisons between the United States and other countries because it is the standard used in international guidelines for economic accounting. It is also possible to adjust GDP for inflation and thus to measure real GDP. In addition to GDP, other economic indicators include a nation's balance of trade, bank credit, corporate profits, consumer price index (CPI), inflation rate, national income, new housing starts, prime interest rate, producer price index (PPI), and unemployment rate.

A nation's economy fluctuates rather than grows at a steady pace every year. These fluctuations are

generally referred to as the business cycle. Generally, the business cycle consists of four states: the peak, recession, the trough, and recovery. Some experts believe that effective use of monetary policy (the Federal Reserve's decisions that determine the size of the supply of money and the level of interest rates) and fiscal policy (the government's influence on the amount of savings and expenditures) can speed up recovery.

5 Outline the four types of competition.

Competition is essentially a rivalry among businesses for sales to potential customers. In a capitalist economy, competition works to ensure the efficient and effective operation of business. Competition also ensures that a firm will survive only if it serves its customers well by providing products and services that meet their needs. Economists recognize four degrees of competition. Ranging from most to least competitive, the four degrees are perfect competition, monopolistic competition, oligopoly, and monopoly. The factors of supply and demand generally influence the price that customers pay producers for goods and services.

6 Summarize the factors that affect the business environment and the challenges that American businesses will encounter in the future.

From the beginning, through the Industrial Revolution of the early 19th century, and to the phenomenal expansion of American industry in the 19th and early 20th centuries, our government maintained an essentially Laissez-Faire attitude toward business. However, during the Great Depression of the 1930s, the federal government began to provide a number of social services to its citizens. The government's role in business has expanded considerably since then.

To understand the major events that shaped the United States during the remainder of the 20th century, it helps to remember that the economy was compared to a roller coaster ride earlier in this chapter—periods of economic growth followed by periods of economic slowdown. Events including wars, rapid economic growth, the social responsibility movement, a shortage of crude oil, high inflation, high interest rates, and reduced business profits all have affected business and the economy.

Now more than ever before, the way a business operates is affected by the competitive environment, global environment, technological environment, and economic environment. As a result, business has a number of opportunities for improvement and challenges for the future.

Key Terms

You should now be able to define and give an example relevant to each of the following terms:

free enterprise (4)	market economy (14)	business cycle (20)	monopolistic
cultural (or workplace) diversity (6)	mixed economy (15)	recession (20)	competition (23)
business (10)	consumer products (15)	depression (20)	product differentiation (23)
profit (11)	command economy (16)	monetary	oligopoly (23)
stakeholders (11)	productivity (17)	policies (21)	monopoly (24)
economics (12)	gross domestic product (GDP) (18)	fiscal policy (21)	natural monopoly (24)
microeconomics (12)	inflation (18)	federal deficit (21)	standard of living (24)
macroeconomics (12)	deflation (18)	national debt (21)	barter (25)
economy (12)	unemployment rate (18)	competition (21)	domestic system (25)
factors of production (12)	consumer price	perfect (or pure)	factory system (26)
entrepreneur (13)	index (CPI) (19)	competition (22)	specialization (26)
capitalism (13)	producer price	supply (22)	e-business (26)
invisible hand (14)	index (PPI) (19)	demand (22)	service economy (27)
		market price (22)	sustainability (28)

Review Questions

1. What reasons would you give if you were advising someone to study business?
2. What factors affect a person's choice of careers?
3. Describe the four resources that must be combined to organize and operate a business. How do they differ from the economist's factors of production?
4. Describe the relationship among profit, business risk, and the satisfaction of customers' needs.
5. What are the four basic economic questions? How are they answered in a capitalist economy?
6. Explain the invisible hand of capitalism.
7. Describe the four basic assumptions required for a Laissez-Faire capitalist economy.
8. Why is the American economy called a mixed economy?
9. Based on Figure 1.5, outline the economic interactions between business and households in our business system.
10. How does capitalism differ from socialism and communism?
11. How is productivity related to the unemployment rate?
12. Define gross domestic product. Why is this economic measure significant?
13. How is the producer price index related to the consumer price index?
14. What are the four steps in a typical business cycle? How are monetary and fiscal policies related to the business cycle?
15. Choose three of the economic measures described in Table 1.2 and describe why these indicators are important when measuring a nation's economy.
16. Identify and compare the four forms of competition.
17. Explain how the equilibrium, or market, price of a product is determined.
18. Four different environments that affect business were described in this chapter. Choose one of the environments and explain how it affects a small electronics manufacturer located in Oregon. Why?

Discussion Questions

1. In what ways have the economic problems caused by the recent crisis in the banking and financial industries affected business firms? In what ways have these problems affected employees and individuals?
2. What factors caused American business to develop into a mixed economic system rather than some other type of economic system?
3. Does an individual consumer really have a voice in answering the basic economic questions?
4. Is gross domestic product a reliable indicator of a nation's economic health? What might be a better indicator?
5. Discuss this statement: "Business competition encourages efficiency of production and leads to improved product quality."
6. In our business system, how is government involved in answering the four basic economic questions? Does government participate in the system or interfere with it?
7. Choose one of the challenges listed on page 29 and describe possible ways in which business and society could help to solve or eliminate the problem in the future.

Video Case 1.1

Entertainment Means Profits for Nederlander Concerts

Nederlander Concerts is based in Los Angeles, one of the two biggest markets in the U.S. concert industry (New York is the other). The company specializes in booking and promoting musical artists like the Goo Goo Dolls, Maroon 5, and Cyndi Lauper in small- to mid-sized venues across the western United States. It owns some of the theaters, amphitheaters, and arenas, including the Greek Theatre in Los Angeles, the Santa Barbara Bowl, the San Jose Civic Theater, and the Grove in Anaheim, and it rents space for concerts and events in other third-party venues along the West Coast. Nederlander Concerts also partners with some of California's major cities such as Santa Monica and San Jose to manage or operate their civic theaters and present events there.

Since Nederlander Concerts deliberately focuses on small- to mid-sized venues, it can offer a unique concert experience that brings audiences and performers closer together. It can therefore sell that high-quality experience at a higher price than seats in a bigger theater yield, and it can more often count on selling out the house, which helps the company and the artists to profit. The concert company's chief operating officer says, "The key areas or departments of the company include talent-buying and marketing, operations, finance, and business development. . . I have a talent-buying team, I have a marketing team, we have a general manager of the building, we have a substantial team of people who take care of the fans, take care of the artist, and look after the shows that we buy. We're in a competitive market, and it's pretty interesting what we do."

Although it might seem odd that the concert business is a competitive one, in fact Nederlander Concerts competes with other promoters (like Live Nation) not just for audiences at its events but for bookings by popular artists. Therefore, it counts as its clients or customers musicians as well as music lovers, and the performers need to be happy with the financial deal they are getting. As Nederlander's chief operating officer explains, "It's not always easy to get the show; there is competition. . . We have a great reputation with the artist. But also there's one other factor, and that's making the deal. That's making your best offer. That's

trying to think about whether the agent is . . . telling you that your competition is paying more, willing to go more. You have to get your own 'I won't go above' number and stop bidding (for the act), or you have to say, 'Okay, I'll pay a little bit more and try to get the show.' So there's a real gamesmanship between agent and buyer . . . the art of the deal is something we live with every day."

Given the talent, how does Nederlander find the audience? Says its vice president of marketing, "It's learning about the market, and picking up every newspaper you can find, listening to every radio station you can find, watching all of the TV, all the news programming . . . it still comes back to, who is the artist, and who is their audience? And how do you find them? . . . The number one reason why people don't go to a show, so they say, is that they don't know about it. Which is infuriating. But we just try to make that percentage of people . . . smaller, and smaller, and smaller."

When everything is going well, the company profits. "Where we like to do most of our business, and in fact is where we probably do 90 percent of our business, is in the venues that we own or operate, so that the risk profile of those shows goes down . . . we have more revenues coming in to ensure that we're able to cover the cost, including the cost of talent, and then walk away with a greater profit."¹⁹

Questions

1. Nederlander Concerts competes for audiences and with other concert arenas and promoters. Do you think it also competes for those audiences with TV, movies, CDs, DVDs, streaming video, and sports events? Why or why not? If yes, what implications does this type of competition have for Nederlander's business?
2. How many different groups can you think of whose needs Nederlander Concerts must satisfy to remain a successful business?
3. Give an example showing how Nederlander Concerts uses each of the four factors of production.

Case 1.2

Caterpillar Helps the World Build

From tractors to turbines, marine engines to mining equipment, Caterpillar makes the heavy equipment that powers progress and helps the world build. Formed in 1925 from the merger of two tractor manufacturers, Caterpillar has grown from its headquarters in Peoria, Illinois, into a successful \$32 billion corporation with 110 factories and business operations in 23 countries. It also offers financing,

insurance, and other services for dealers and business customers that buy its industrial products.

Caterpillar's sales contribute to the global economy by creating jobs for 94,000 in the company (including 44,000 employees located in North America) as well as for tens of thousands of workers employed by its network of suppliers and dealers. At the same time, Caterpillar's sales are affected,

in large part, by local, regional, and international economic conditions. When the economy is expanding, customers such as construction firms need earthmoving equipment to tackle major projects, such as new housing, highways, pipelines, and mass transit systems. They also need demolition equipment, which Caterpillar makes, to clear the way for new projects.

During recessions, however, companies and governments often postpone or go slow on these types of projects, which in turn dampens demand for earthmovers and similar machinery. Still, Caterpillar has profited from the ongoing building boom in developing nations, where many infrastructure improvements move ahead regardless of what's happening in the rest of the world. These days, 69 percent of its sales come from outside the United States, up from 53 percent of sales just five years ago. Not surprisingly, Caterpillar's main competition in the global marketplace comes from multinational giants, such as Komatsu (based in Japan), CNH Global (based in the Netherlands), and Volvo (based in Sweden).

Before Caterpillar builds a new factory, it carefully researches the market. Recently, for example, it undertook a study of regional and global demand for excavating equipment. Although Caterpillar already operates excavator factories in the United States, Japan, and six other countries, it may open a new U.S. plant to serve all of North America if demand is strong enough. Instead of importing some models from its factory in Japan, as it does now, Caterpillar would make those products in the U.S. plant and have the Japanese facility make models that sell well in Asia.

Stepping up to sustainability, Caterpillar is going green on a global scale. It is constantly improving the efficiency of its products, reducing its use of power, doing more to recycle materials and cut waste, and finding new uses for

old products. The company also offers training to help customers cut the amount of fuel they need to power their Caterpillar equipment, which saves users money as well as helps conserve scarce resources.

As a good corporate citizen, Caterpillar makes donations to non-profit organizations that support educational, health, and human services projects. It also contributes to environmental conservation organizations that protect natural resources and enhance sustainability around the world. Through the Caterpillar Employees United Way Appeal, the company and its employees make yearly donations to United Way groups in their local communities.

Caterpillar's managers and employees are required to follow the company's worldwide code of conduct in all their business dealings with suppliers, dealers, customers, and competitors. The code sets high standards for honest, ethical behavior; outlines how Caterpillar deals with potential conflicts of interest; and strictly forbids the use of "improper payments" such as bribes and kickbacks. Here's how the company sums up its commitment to being a responsible business: "We are global citizens and responsible members of our communities who are dedicated to safety, care for our environment, and manage our business ethically."²⁰

Questions

1. How is Caterpillar using the factors of production to fuel global growth?
2. How would you characterize Caterpillar's competitive situation? What are the implications for how it does business?
3. What factors in the business environment appear to have the most influence on Caterpillar's ability to continue its business success? Explain.

Building Skills for Career Success



1 JOURNALING FOR SUCCESS

Much of the information in this chapter was designed to get you to think about what it takes to be a successful employee in the competitive business world.

Assignment

Assume that you are now 25 years old and are interviewing for a position as a management trainee in a large corporation. Also assume that this position pays \$45,000 a year.

1. Describe what steps you would take to prepare for this interview.
2. Assuming that you get the management trainee position, describe the personal traits or skills that you have that will help you to become successful.

3. Describe the one personal skill or trait that you feel needs improvement. How would you go about improving your weakness?

2 EXPLORING THE INTERNET

The Internet is a global network of computers that can be accessed by anyone in the world. For example, your school or firm is most likely connected to the Web. You probably have access through a commercial service provider such as AT&T, Yahoo!, or a host of other smaller Internet service providers.

To familiarize yourself with the wealth of information available through the Internet and its usefulness to business students, this exercise focuses on information services available from a few popular search engines used to explore the Web.

To use one of these search engines, enter its Internet address in your Web browser. The addresses of some popular search engines are

<http://www.ask.com>

<http://www.google.com>

<http://www.msn.com>

<http://www.yahoo.com>

Visit the text Web site for updates to this exercise.

Assignment

1. Examine the ways in which two search engines present categories of information on their opening screens. Which search engine was better to use in your opinion? Why?
2. Think of a business topic that you would like to know more about; for example, careers, gross domestic product, or another concept introduced in this chapter. Using your preferred search engine, explore a few articles and reports provided on your topic. Briefly summarize your findings.

3 DEVELOPING CRITICAL-THINKING SKILLS

Under capitalism, competition is a driving force that allows the market economy to work, affecting the supply of goods and services in the marketplace and the prices consumers pay for those goods and services. Let's see how competition works by pretending that you want to buy a new car.

Assignment

1. Brainstorm the following questions:
 - a. Where would you go to get information about new cars?
 - b. How will you decide on the make and model of car you want to buy, where to buy the car, and how to finance it?
 - c. How is competition at work in this scenario?
 - d. What are the pros and cons of competition as it affects the buyer?
2. Record your ideas.
3. Write a summary of the key points you learned about how competition works in the marketplace.

4 BUILDING TEAM SKILLS

Over the past few years, employees have been expected to function as productive team members instead of working alone. People often believe that they can work effectively in teams, but many people find working with a group of people to be a challenge. Being an effective team member

requires skills that encourage other members to participate in the team endeavor.

College classes that function as teams are more interesting and more fun to attend, and students generally learn more about the topics in the course. If your class is to function as a team, it is important to begin building the team early in the semester. One way to begin creating a team is to learn something about each student in the class. This helps team members to feel comfortable with each other and fosters a sense of trust.

Assignment

1. Find a partner, preferably someone you do not know.
2. Each partner has two to three minutes to answer the following questions:
 - a. What is your name, and where do you work?
 - b. What interesting or unusual thing have you done in your life? (Do not talk about work or college; rather, focus on such things as hobbies, travel, family, and sports.)
 - c. Why are you taking this course, and what do you expect to learn? (Satisfying a degree requirement is not an acceptable answer.)
3. Introduce your partner to the class. Use one to two minutes, depending on the size of the class.

5 RESEARCHING DIFFERENT CAREERS

In this chapter, *entrepreneurship* is defined as the willingness to take risks and the knowledge and ability to use the other factors of production efficiently. An *entrepreneur* is a person who risks his or her time, effort, and money to start and operate a business. Often, people believe that these terms apply only to small business. However, employees with entrepreneurial attitudes have recently advanced more rapidly in large companies as well.

Assignment

1. Go to the local library or use the Internet to research how large firms, especially corporations, are rewarding employees who have entrepreneurial skills.
2. Find answers to the following questions:
 - a. Why is an entrepreneurial attitude important in corporations today?
 - b. What makes an entrepreneurial employee different from other employees?
 - c. How are these employees being rewarded, and are the rewards worth the effort?
3. Write a two-page report that summarizes your findings.