LEARNING OBJECTIVES

1. Discuss your future 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. Examine the four different phases in the typical business cycle.
6. Outline the four types of competition.
7. Summarize the factors that affect the business environment and the challenges American businesses will encounter in the future.

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IBM Reinvents Its Future

International Business Machines (IBM) knows how to change with the times and technology. Founded in 1911 as the Computing-Tabulating-Recording Company, it originally made mechanical time-clocks and adding machines for U.S. and Canadian businesses. Today, IBM employs more than 400,000 worldwide, rings up $103 billion in annual revenue, and offers a wide range of information technology products and services for consumers and business customers.

The company has been reinventing itself year after year for nearly a century, entering new markets, filing new patents, and finding new paths to profit. IBM expanded into Europe, Latin America, and Asia during the 1920s. It introduced automated computing equipment in the 1940s and by the 1950s, it was manufacturing giant computers bundled with programs for billing, payroll, and inventory control. In 1960, IBM began tailoring computer and software packages to the needs of individual business customers, a move that launched the company into the lucrative market for technology services.

During the 1980s, IBM revolutionized business computing when it introduced the desktop personal computer. As the Internet Age dawned during the 1990s, the firm expanded into network servers and electronic commerce services. In 2005, it sold its PC business to Lenovo so it could focus on technology products and services for businesses of all sizes. Despite intense competition from Hewlett-Packard and other rivals, IBM has continued to prosper in the past decade by deemphasizing equipment in favor of more profitable software and services.

Whether the global economy expands or contracts, IBM is ready for all kinds of challenges and opportunities. It has $14 billion in cash to acquire compatible businesses, pay for advanced research, and construct new facilities. More than 70 percent of its skilled workforce is now located outside the United States, in nations where costs are low and growth is brisk. Every year, IBM files more than 4,000 patents and commercializes hundreds of scientific discoveries. In short, it’s a century-old company that’s always on the cutting edge.

Economic Crisis! Just two words, but these same two words will change the way that the world does business in the future. While the United States along with other countries around the globe were experiencing an economic meltdown that rivals the “Great Depression,” businesses and individuals were also suffering. Virtually, every person was affected in some way by the economic crisis that began in late 2007. Just for a moment, think about the economic problems below and how they affect not only businesses, but also individuals.

- Unemployment rates approaching 10 percent
- Reduced consumer spending
- A slowdown in the homebuilding industry
- Automobile manufacturers file for bankruptcy
- A large number of troubled banks, savings and loan associations, and financial institutions on the verge of financial collapse
- An increasing number of business failures
- Depressed stock values that reduced the value of investment and retirement accounts for most individuals

In spite of the efforts of the federal government to provide the economic stimulus needed to stabilize the economy, the nation was still in the midst of recession when this text was published. Hopefully, by the time you read this material, the nation’s economy will be improving. 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. Also, it helps to keep one factor in mind. Despite all of the problems described above, 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.

Our economic system provides an amazing amount of freedom that allows businesses that range in size from the small corner grocer to ExxonMobil 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 Dell Computer can buy parts from Intel and software from Microsoft and manufacture its own computers. Our system gives Dell’s owners the right to make a profit from the company’s success. It gives Dell’s management the right to compete with Hewlett-Packard, Sony, and IBM. And it gives computer buyers the right to choose.

In this chapter, we look briefly at what business is and how it got that way. First, we discuss your future in business and explore some important reasons for studying business. Then we define business, noting how business organizations satisfy 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 the four phases in a typical business cycle. We also outline different types of competition. Next, we look at the events that helped shape today’s business system, the current business environment, and the challenges that businesses face.

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 now 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, or an unemployed worker looking for work, 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. 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 television show, Joe Dudley, one of the world’s most successful black business owners, gave the preceding advice to anyone who wants to succeed in business. And his advice is an excellent way to begin our discussion of what free enterprise is all about. 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 hair-care products and to open a chain of beauty schools and beauty supply stores. Today, Mr. Dudley has built a multimillion-dollar empire and is president of Dudley Products, Inc. Not only a successful business owner, he is also a winner of the Horatio Alger Award—an award given to outstanding individuals who have succeeded in the face of adversity. While 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 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 jour-
ney, not just a destination.”

Whether you want to obtain part-time employ-
ment 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. 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 a college education are
enormous. To begin with, there are economic ben-
efits. Over their lifetimes, college graduates on aver-
age earn much more than high school graduates. And
while lifetime earnings are substantially higher for
college graduates, so are annual income amounts—
see the Spotlight feature to the left.
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 four quite compelling reasons for
studying business.

For Help in Choosing a Career What do you want to do with the rest
of your life? Someplace, sometime, someone probably has asked you this same
question. And 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 Marriot International. 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 what career might be right for you, read Appendix B: Careers
in Business, which appears at the end of this text.

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

- Career Builder at www.careerbuilder.com
- Career One Stop at www.careeronestop.org
- Monster at 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
thirty. 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 in order to get promo-
tions 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 the you is a very important part of
that decision.
Managing Your Career

Interviewing the Interviewer

Part of getting ready for a job interview is practicing answers to questions such as “What are your strengths and weaknesses?” Being prepared with questions to ask the interviewer is just as important. If you have no questions, the interviewer may think you don’t care about the job or haven’t given much thought to the interview. Here are a few questions to keep the conversation flowing and help you make up your mind about a particular position:

- What are the main challenges I can expect to face in this job? (Learn as much as you can about potential problems upfront.)
- What skills and training are especially critical to success in this job? (See whether your qualifications fit the job.)
- What are the company’s goals and how would an effective employee in this job help achieve those goals? (Find out where the company is headed and how this job contributes to its success.)


To Be a Successful Employee

Deciding on the type 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 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, 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 don’t underestimate your part in making your dream a reality. It will take hard work, dedication, perseverance, and time management to achieve your goals. Communication skills are also important. Today, most employers are looking for employees who can compose a business letter and get it in mailable form. They also want employees who can talk with customers and use e-mail to communicate with people within and outside the organization. Employers also will 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 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. And because Cuban’s company met the needs of its customers, Broadcast.com was very successful. When Cuban sold Broadcast.com to Yahoo! Inc., he became a billionaire.

Unfortunately, many small-business firms fail; two thirds of them fail within the first six 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 also will 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 hybrid Prius car from the local Toyota 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.” 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. And while this is an obvious conclusion, just dreaming of being rich doesn’t 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*. In fact, *learning about business and how you can be involved as an employee, business owner, consumer, or investor can be fun!*

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 environmental issues, career information, starting a business, ethical behavior, and the economic crisis.
• **Spotlight** features highlight interesting facts about business and society and often provide a real-world example of an important concept within a chapter.
• **End-of-chapter materials** provide a chapter summary, a list of key terms, discussion questions, a “Test Yourself” quiz, and a video case. The last section of every chapter is entitled Building Skills for Career Success and includes exercises devoted to exploring the Internet, building team skills, and researching different careers.
• **End-of-part materials** provide a continuing video case about the Finagle A Bagel company that operates a chain of retail outlets in the northeastern section of the United States. 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 website that accompanies this edition. There, you will find online study aids, including interactive study tools, practice tests, games for each chapter, flashcards, and other resources. If you want to take a look at the Internet support materials available for this edition of *Foundations of Business.*

1. Make an Internet connection and go to [www.cengage.com/introbusiness](http://www.cengage.com/introbusiness/)
2. Click on the Book Companion Site link and choose Select a Chapter.

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. In order 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 a destination.”

### TABLE 1.1: Seven Ways to Use This Text and Its Resources

<table>
<thead>
<tr>
<th>1. Prepare before you go to class.</th>
<th>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 exams.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Read the chapter.</td>
<td>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.”</td>
</tr>
<tr>
<td>3. Underline or highlight important concepts.</td>
<td>Make this text yours. Don’t be afraid to write on the pages of your text. It is much easier to review material if you have identified important concepts.</td>
</tr>
<tr>
<td>4. Take notes.</td>
<td>While reading, take the time to jot down important points and summarize concepts in your own words. Also, take notes in class.</td>
</tr>
<tr>
<td>5. Apply the concepts.</td>
<td>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.</td>
</tr>
<tr>
<td>6. Practice critical thinking.</td>
<td>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.</td>
</tr>
<tr>
<td>7. Prepare for exams.</td>
<td>Allow enough time to review the material before exams. Check out the summary and questions at the end of the chapter. Then use the resources on the text website.</td>
</tr>
</tbody>
</table>
Since a text always should 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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**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”) or within an industry (as in “the steel 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 and talents 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. And **information** is the resource that tells the managers of the business how effectively the other resources are being combined and used (see Figure 1.1).

Today, businesses usually are organized as one of three specific types. **Manufacturing businesses** process various materials into tangible goods, such as delivery trucks or furniture. 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. And 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

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**FIGURE 1.1: Combining Resources** A business must combine all four resources effectively to be successful.
remote-control side mirrors. Others may believe that a small Smart car 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 more than 4,100 retail stores in the United States and more than 3,100 retail stores in thirteen different countries, this highly successful discount-store organization continues to open new stores to meet the needs of its customers around the globe.

**Business Profit**

A business receives money (sales revenue) from its customers in exchange for goods or services. It also must 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 1.2, 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. One of the big concerns during the recent economic crisis was the fear that the number of business failures would increase. As the crisis worsened, the fear became a reality as an increasing number of both small and large businesses experienced reduced sales revenues and losses and eventually failed. To avoid failure and improve a firm’s chances of success, management and employees must find some way to increase sales revenues and/or reduce expenses in order to return to profitability. If some specific actions aren’t 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 Enron, WorldCom, and mortgage-lenders Fannie Mae and Freddie Mac 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 decisions made by an organization.

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**Oil or wind power?** To protect the environment as well as to reduce our dependence on foreign nations, many utility companies are developing alternative energy sources such as “wind power.” Once developed, these new energy sources may actually be cheaper than using foreign oil. For business firms, reduced energy costs can increase profits. For consumers, reduced energy costs can mean there is more money for spending or investing.

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**Concept Check**

1. Describe the four resources that must be combined to organize and operate a business.
2. What is the difference between a manufacturing business, a service business, and a marketing intermediary?
3. Explain the relationship among profit, business risk, and the satisfaction of customers’ needs.
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 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 assume 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 those 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, 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. You must decide what is most important. Business firms, governments, and to some extent society face the same types of decisions. And each group must deal with scarcity when making important decisions. In this case, *scarcity* means “lack of resources”—money, time, natural resources, etc.—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 built and sold. On the other hand, **macroeconomics** is the study of the national economy and the global economy. Macroeconomics examines the economic effect of taxes, government spending, interest rates, and similar factors on a nation and society. With record home foreclosures, troubled banks on the verge of failure, and stock values dropping on Wall Street, a real application of macroeconomics occurred when the U.S. Congress enacted and President Bush signed the Emergency Economic Stabilization Act of 2008. The **Emergency Economic Stabilization Act** was a $700 billion bailout plan created to stabilize the nation’s economy and restore confidence in the banking and financial industries. While the politicians, the president, economists, business leaders, and the general public still debate the merits of a federal rescue plan, one factor became very apparent. Something had to be done to correct what some experts described as the nation’s worst economic problems since the Great Depression.

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.
- **Capital**—the money, facilities, equipment, and machines used in the operation of organizations. While most people think of capital as just money, it also can
be the manufacturing equipment in a Coca Cola bottling facility or a computer used in the corporate offices of McDonald’s.

• **Entrepreneurship**—the resource 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. 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 below 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 eighteenth-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 of a business owner. According to Smith, when an individual is acting to improve his or her own fortunes, he or she indirectly promotes the good of his or her 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 some workers 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 described below (see Figure 1.3).

1. The creation of wealth is properly the concern of private individuals, not 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.

One factor that Smith felt was extremely important was the role of government. He believed 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 those resources are used and also should be free to enjoy the income, profits, and other benefits derived from ownership of those 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 government participates as more than umpire and rule maker. Our economy, 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 1.4.

**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. 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 those 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 1.4 is continuous.

Along the way, of course, business owners would like to remove something from the circular flow in the form of profits. And households try to retain some income 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 also can 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.) And, as we saw, household income is retained in the circular flow as either consumer spending or invested savings. Thus, business profits, too, are retained in the business system, and the circular flow is complete. How, then, does government fit in?

**Governments** The framers of our Constitution desired as little government interference with business as possible. At the same time, the United States Constitution sets forth the responsibility of government to protect and promote the public welfare. Local, state, and federal governments discharge this responsibility through regulation and the provision of services. The numerous government services are important but either (1) would 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 and fire protection, education, and construction of roads and highways. In addition to the typical services citizens expect, the government recently has created a number of stimulus packages in an attempt to improve the nation’s sagging economy. These programs, which will cost American taxpayers billions of dollars, are designed to reduce the effects of the economic crisis, move the economy from recession to recovery, improve regulation of financial and insurance firms, and eliminate the problems that caused the nation’s economic downturn. 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 1.4 shows this exchange of taxes for government services. It also shows government spending of tax dollars for resources and products required to provide those 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 also may be the property of the state in a socialist economy. Depending on the country, private ownership of smaller businesses is permitted to varying degrees. People usually may choose their own occupations, but many work in state-owned industries.

In a socialist economy,

- 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.

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.
Among the professed aims of socialist countries are the equitable distribution of income, the elimination of poverty, the distribution of social services (such as medical care) to all who need them, and the elimination of the economic waste that supposedly accompanies capitalist competition. 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 traditionally have been labeled as socialist nations, including France, Sweden, and India, are transitioning to a free-market economy. And currently, many countries that once were thought of as communist countries are now often referred to as socialist countries. Examples of former communist countries often referred to as socialists (or even capitalist) include most of the nations that were formerly part of the Union of Soviet Socialist Republics (USSR), 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-nineteenth century, Marx advocated a classless society whose citizens together owned all economic resources. All workers then would 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.

Typical conditions in a communist economy include:

- The government owns almost all economic resources.
- The basic economic questions are answered through centralized state plans.
- 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.

In a communist country, workers have little choice of jobs, but special skills or talents seem to be rewarded with special privileges. Various groups of professionals (bureaucrats, university professors, and athletes, for example) fare much better than, say, factory workers.

**Measuring Economic Performance**

Today, it is hard to turn on the radio, watch the news on television, 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?
- 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.

**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. Productivity growth in the United States has increased dramatically over the last several years. For example, overall productivity...
Part 1: The Environment of Business

growth averaged 2.5 percent for the period from 1995 through 2008.\(^8\) (Note: At the
time of publication, 2008 was the last year that complete statistics were available.)
This is an extraordinary statistic when compared against historical standards. And
yet, before you think that all the nation’s productivity problems are solved, consider
the following questions:

**Question:** How does productivity growth affect the economy?

**Answer:** Because of productivity growth, it now takes fewer workers to produce prod-
ucts. As a result, employers have reduced costs, earned more
profits, and/or sold their products for less. Finally,
productivity growth helps American
business to compete more
effectively with other nations
in a competitive world.

**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. Methods used to increase productivity
are discussed in detail in Chapter 8.

**Question:** Is productivity growth always good?

**Answer:** While economists always point to increased efficiency and the ability to
produce goods and services for lower costs as a positive factor, fewer workers pro-
ducing 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.

Employers in Japan, China, Korea, Taiwan, Germany, and other countries
throughout the world are also concerned about productivity. For example, consider
the economic growth of China. About 200 years ago, Napoleon returned from China
and said, “That is a sleeping dragon. Let him sleep! If he wakes up he will shake the
world.” Today, China is awake and is shaking the world. Increased productivity has
enabled the Chinese to manufacture products that range from trinkets to sophisticated
electronic and computer products. And China is just one country. There are many
other countries that understand the economic benefits of increased productivity.

### 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 value of
automobiles produced by employees in both an American-owned Ford 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 2008.\(^9\) 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 pos-
sible 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 experienc-
ing economic growth.

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

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**Note:** 

[8] At the time of publication, 2008 was the last year that complete statistics were available.

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 1.5 depicts the GDP of the United States in current dollars and the real GDP in inflation-adjusted dollars. Note that between 1985 and 2008, America’s real GDP grew from $6.1 trillion to $11.7 trillion.11

![Figure 1.5: GDP in Current Dollars and in Inflation-Adjusted Dollars](image)


### Concept Check

1. How does an increase in productivity affect business?

2. Define gross domestic product. Why is this economic measure significant?

3. How does inflation affect the prices you pay for goods and services?

4. How is the producer price index related to the consumer price index?
Global Economic Challenges

Cycling through the Business Cycle

How do companies prepare for the ups and downs of the global business cycle? First they need to recognize early warning signs of a significant change in economic activity. An early warning sign for the high-tech industry would be sales of commonly-used components such as memory chips. A downturn in chip sales—more than a momentary blip—suggests the economy is headed into recession; conversely, an upturn in chip sales usually indicates recovery ahead.

During the recent recession, after reporting month after month of lower sales, chip-maker Intel announced that chip sales were slowly but steadily increasing, especially in China and the United States. That’s when Hewlett-Packard and other PC makers realized that the economic trough was behind them.

For furniture manufacturers, plumbing supply firms, home improvement retailers, and other businesses that profit from a boom in housing and office construction, the number of building permits is a leading economic indicator. When these businesses note that more permits are being issued in a particular area, they know to prepare for future growth.

However, the business cycle affects different industries in different ways. For example, if steel producers see more building permits being issued, they also have to look at worldwide conditions in the automotive industry before they crank up steel output.


In addition to GDP and real GDP, other economic measures exist that can be used to evaluate a nation’s economy. 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 and 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’s price index. The producer price index (PPI) measures prices at the wholesale level. Since 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 terms 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.

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 generally are 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, the U.S. economy was in a recession caused by a depressed housing market and related problems in the banking and financial industries. Unemployment rates were high, and people were frightened by the prospects of a prolonged downturn in the economy. To help restore confidence in the economy, the Emergency Economic Stabilization Act was passed.
by Congress and signed by president George W. Bush. This $700 billion bailout plan was designed to aid the nation’s troubled banks and Wall Street firms and restore confidence in the nation’s economy. The bill also contained provisions to help individuals weather the economic storm. It was the hope that the bailout plan along with an economic stimulus package enacted by Congress and signed by president Barack Obama in 2009 would help the nation turn the corner from recession to recovery.

The changes that result from either growth or recession 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, unemployment is low, and 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 in order to take advantage of consumers’ increased buying power.

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 or unnecessary 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 recession. A depression is characterized by extremely high unemployment rates, low wages, reduced purchasing power, lack of confidence in the economy, and a general decrease in business activity. While many politicians, the president, economists, business leaders, and the general public debate if we are in a recession or a depression, one thing is certain, the economic problems that began in October 2007 have created the worst economic crisis the United States has experienced since the Great Depression.

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 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 $2.5 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 2009. The total of all federal deficits is called the

A job search can be frustrating. Often a nation’s unemployment rate is a key indicator that can gauge a nation’s economy. In this photo, eager job applicants wait in line to interview with New York utility company Con Edison.

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Chapter 1: Exploring the World of Business and Economics

1. What are the four steps in the typical business cycle?

2. At the time you are studying the material in this chapter, which phase of the business cycle do you think the U.S. economy is in? Justify your answer.

3. How has the government used monetary policy and fiscal policy to reduce the effects of the economic crisis?
national debt. Today, the U.S. national debt is $11 trillion, or approximately $36,500 for every man, woman, and child in the United States. 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.

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 eleven months. While the Federal Reserve has used monetary policy to reduce the effects of a sagging economy and the federal government has implemented economic stimulus programs to increase consumer spending, the nation is still experiencing economic problems.

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 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 capitalist 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.

**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, say, bushels of wheat. Second, all sellers offer essentially the same product for sale. Third, 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 fourth, the overall market is not affected by the actions of any one buyer or seller.

<table>
<thead>
<tr>
<th>Number of Business</th>
<th>Type of Competition</th>
<th>Firms or Suppliers</th>
<th>Real-World Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Perfect</td>
<td>Many</td>
<td>Corn, wheat, peanuts</td>
<td></td>
</tr>
<tr>
<td>2. Monopolistic</td>
<td>Many</td>
<td>Clothing, shoes, furniture</td>
<td></td>
</tr>
<tr>
<td>3. Oligopoly</td>
<td>Few</td>
<td>Automobiles, cereals</td>
<td></td>
</tr>
<tr>
<td>4. Monopoly</td>
<td>One</td>
<td>Software protected by copyright, local public utilities</td>
<td></td>
</tr>
</tbody>
</table>
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. But that seller would lose sales revenue (and profit) because buyers actually are 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.

**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 1.6.

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 1.6.

**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 2 million bushels of wheat at a price of $8 per bushel and that buyers are willing to purchase 2 million bushels at a price of $8 per bushel. In other words, supply and demand are in balance, or in equilibrium, at the price of $8. Economists call this price the market price. The market price of any product is the price at which the quantity demanded is equal to the quantity supplied. If suppliers produce 2 million bushels, then no one who is willing to pay $8 per bushel will have to go without wheat, and no producer who is willing to sell at $8 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 who differentiate their products from the products of competitors. 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 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, airlines, car rental, cereal, and farm implement industries.

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, Chrysler, 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 auto manufacturers. For instance, when General Motors began offering employee-discount pricing, Ford and Chrysler also launched competitive financing deals.

Monopoly

A monopoly is a market (or industry) with only one seller. 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 soon would find that it had 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. 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. While 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 the federal government issues a copyright, patent, or trademark. Each of these exists for a specific period of time and can be used to protect the owners of written materials, ideas, or product brands 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 limited-monopoly position. Except for natural monopolies and monopolies created by copyrights, patents, and trademarks, federal antitrust laws prohibit both monopolies and attempts to form monopolies.

**American Business Today**

While 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 opportunity 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 1.7 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 ships that called at the colonies. **Barter** is a system of exchange in which goods or services are traded directly for other goods and/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, 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. Elias Howe’s sewing machine became available to convert materials into clothing. The agricultural machinery of John Deere and Cyrus McCormick revolutionized farm production. At the same time, new means of transportation greatly expanded the domestic markets for American products. Many business historians view the period from 1870 to 1900 as the second Industrial Revolution.

**LEARNING OBJECTIVE**

Summarize the factors that affect the business environment and the challenges American businesses will encounter in the future.
Certainly, many characteristics of our modern business system took form during this time period.

**The Twentieth Century**

Industrial growth and prosperity continued well into the twentieth 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.

The economy was on the road to recovery when World War II broke out in Europe in 1939. The need for vast quantities of war materials spurred business activity and technological development. This rapid economic pace continued after the war, and the 1950s and 1960s witnessed both increasing production and a rising standard of living.

In the mid-1970s, however, a shortage of crude oil led to a new set of problems for business. As the cost of petroleum products increased, a corresponding price increase took place in the cost of energy and the cost of goods and services. The result was inflation at a rate well over 10 percent per year during the early 1980s. Interest rates also increased dramatically, so both businesses and consumers reduced their borrowing. Business profits fell as the purchasing power of consumers was eroded by inflation and high interest rates.

By the early 1990s, unemployment numbers, inflation, and interest—all factors that affect business—were now at record lows. In turn, business took advantage of this economic prosperity to invest in information technology, cut costs, and increase flexibility and efficiency. 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.

Unfortunately, by the last part of the twentieth 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 first few years of the twenty-first century 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 now could 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 and increasing opportunities for global trade also changed the way American firms do business in the twenty-first century. Because they employ approximately 85 percent of the American work force, service businesses are a very important component of our economy.14 As a result, service businesses must find ways to improve productivity and cut costs while at the same time providing jobs for an even larger portion of the work force.

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 17 indicate troubling economic problems, there is still a certain amount of pessimism surrounding the economy. At the time of publication, many people wonder how much longer the economic crisis will last. Unfortunately, even the experts can’t agree on an answer. Unemployment rates are still abnormally high, stock market values are still depressed, and a large number of businesses are experiencing financial problems that may eventually lead to failure—despite the fact that federal government is spending billions of dollars of taxpayer money to fund massive economic stimulus programs. Hopefully, by the time you read this material, our economy will have reached the bottom of the trough and will have begun to recover.

**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 of 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. Just for a moment, review the definition on page 8.

Note the phrase *satisfy society’s needs*. Those 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 once was a time when the label “Made in the United States” gave U.S. businesses an inside edge both at home and in the global marketplace. Now, businesses in 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.”

While both foreign competition and technological innovation have changed the way we do business, the technology environment for U.S. businesses has never been more challenging. Changes in manufacturing equipment, communication with customers, and distribution of products are all examples of how technology has changed everyday business practices. And the technology will continue to change. New technology will require businesses to spend additional money to keep abreast of an ever-changing technology environment.

In addition to the competitive, global, and technology environments, the economic environment always must be considered when making business decisions. While 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 to three years because of economic concerns related to the depressed housing, 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. A combination of forces including economic factors, growth in population, increased energy use, and concerns for the environment are 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 affects the way a business does business. As a result, there are always opportunities for improvement and challenges that must be considered.

### 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 and the economic problems of the 1970s, the 1980s, and the economic crisis that began in late 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. But often 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?
- How can we restore the public’s confidence in the banking and financial industries?
- How can we regulate banks, savings and loan associations, credit unions, and other financial institutions to prevent the type of abuses that led to an economic crisis?
- How can we encourage Iraq and Afghanistan to establish a democratic and free society and resolve possible conflict with North Korea and other countries throughout the world?
- How can we meet the challenges of managing culturally diverse workforces to address the needs of a culturally diverse marketplace?
- How can we make American firms more productive and more competitive with foreign firms who have lower labor costs?
- How can we preserve the benefits of competition and small businesses 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?

The answers to these questions are anything but simple. In the past, Americans always have been able to solve their economic problems through ingenuity and creativity. Now, as we continue the journey through the twenty-first century, we need that same ingenuity and creativity not only to solve our current problems but also...
to compete in the global marketplace. 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.

**SUMMARY**

1. **Discuss your future 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 same people then 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, or an unemployed worker looking for work, 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 road map, that ensures that you have the necessary skills and the knowledge the job requires to become a better employee. 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.

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 (land and natural resources, labor, capital, and entrepreneurship) 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.

   Our economic system today is a mixed economy. In the circular flow that characterizes our business system (see Figure 1.4), households and businesses exchange resources for goods and services, using money as the medium of exchange. In a similar manner, 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 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) also can 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, consumer price index (CPI), corporate profits, inflation rate, national income, new housing starts, prime interest rate, producer price index (PPI), and unemployment rate.

5. **Examine the four different phases in the typical business cycle.**

   A nation’s economy fluctuates rather than grows at a steady pace every year. These fluctuations generally are referred to as the business cycle. Generally, the business cycle consists of four states: the peak (sometimes referred to as prosperity), 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 policies (the government’s influence on the amount of savings and expenditures) can speed up recovery and even eliminate depressions for the business cycle. For example, the Emergency Economic Stabilization Act was enacted in late 2008 to help restore confidence in the economy, help individuals weather the economic crisis, and help the nation turn the corner from recession to recovery. This act, when combined with later stimulus bills passed in 2009, have created a federal deficit—a situation where the government spends more than it receives during one fiscal year. The total of all federal deficits is called the national debt.

**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. 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 consumers pay producers for goods and services. The market price for any product is the price at which the quantity demanded is equal to the quantity supplied.

**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 nineteenth century, and to the phenomenal expansion of American industry in the nineteenth and early twentieth 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. Government’s role in business has expanded considerably since that time.

During the 1970s, a shortage of crude oil led to higher prices and inflation. In the 1980s, business profits fell as the consumers’ purchasing power was eroded by inflation and high interest rates. By the early 1990s, the U.S. economy began to show signs of improvement and economic growth. Unemployment numbers, inflation, and interest rates—all factors that affect business—were now at record lows. Unfortunately, by the last part of the 1990s, a larger number of business failures and declining stock values were initial signs that more economic problems were on the way.

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.