2 Understanding ECONOMICS and HOW IT AFFECTS Business

LEARNING **goals**

After you have read and studied this chapter, you should be able to

1 Explain basic economics.

2 Explain what capitalism is and how free markets work.

3 Compare socialism and communism.

4 Analyze the trend toward mixed economies.

5 Describe the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.

6 Contrast fiscal policy and monetary policy, and explain how each affects the economy.

profile

CONNECTING WITH

Steven Levitt and Stephen Dubner,

Authors of *Freakonomics*

Like many academic fields, economics can be dense and uninviting to newcomers. At economics' highest level, scholars analyze enormous amounts of data with complex mathematical equations that can seem like an alien language to the uninitiated. Even the government's leading financial advisors appear to have trouble agreeing on what's happening in the economy at any given time.

Still, each one of us participates in the economy every day. We should all at least have a basic understanding of the system we engage with on a daily basis. At its best economics can teach us more about ourselves rather than just the mechanics of supply and demand. That's exactly what Steven Levitt and Stephen Dubner set out to prove with their best-selling book *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything.* In the book, the authors combined economic analysis with elements of pop culture and sociology in order to gain a better understanding of how our world works. For instance, one chapter analyzed data about Japanese sumo wrestling to expose the rampant culture of corruption that had taken hold of the sport. Another chapter took a serious look at the economics of drug dealing and found the wages to be poor and the working conditions unlivable.

With unusual and interesting studies like these, Levitt and Dubner went on to sell four million copies of *Freakonomics* in 35 languages. So how did this book on economics turn into such a blockbuster? Surprisingly, it almost wasn't written at all. The authors were not colleagues before collaborating on this project. Steven Levitt was a respected economist at the University of Chicago who had earned degrees from prestigious institutions like Harvard University and M.I.T. Stephen Dubner, on the other hand, took a slightly different route to professional success. He had been set on becoming a writer since age 11, when he had his first piece published in *Highlights* magazine. However, his life took a bit of a detour when he formed a band while studying at Appalachian State University. The band was signed by Arista Records, which brought Dubner to New York City. Although he eventually bowed out of the music business, Dubner used his time in the Big Apple to get a master's degree in writing from Columbia University. Along with working for several high-profile publications, Dubner also penned a number of books.

By the early 2000s, Dubner was working on a manuscript about the "psychology of money" when an editor for *The New York Times Magazine* suggested he write a profile of Steven Levitt. Dubner was reluctant to take the project since he didn't think Levitt could provide much information for the book. "Fact is that Levitt has almost no interest in either psychology *or* money," says Dubner. After reading some of Levitt's scholarly papers, though, Dubner realized he wasn't dealing with any ordinary economist. "He was as creative and clever as an economist as I'd always tried to be as a writer, but he was much more successful!" says Dubner. The resulting profile created so much buzz that both men were approached to write books on the unexplored aspects of social economics. Rather than compete, in 2005 the two joined forces to create *Freakonomics.*

Once the book became a massive success, Levitt and Dubner turned their concept into a successful brand. Along with releasing a documentary film feature and 2009's book sequel *Superfreakonomics,* the pair also operate a *Freakonomics* blog, radio show, and popular podcast. Through these outlets, Levitt and Dubner can continue to study "the hidden side of everything" in the fast-paced world of online publishing. Furthermore, should the two decide to collaborate on another book, their brand name will remain fresh in the public's mind.

Outside of the *Freakonomics* spectrum, Levitt is the co-founder of The Greatest Good, a business and philanthropy consulting company. "Unfortunately, the way philanthropy is currently done, it is difficult to know what impact you'll have," says Levitt. "Very few charities engage in measuring their impact in a meaningful way." Using data analysis similar to Levitt's research in *Freakonomics,* The Greatest Good aims to use cutting-edge economic methods to solve the philanthropy world's biggest problems.

Many people don't realize the importance of the economic environment to the success of business. That is what this chapter is all about. You will learn to compare different economic systems to see the benefits and the drawbacks of each. You will learn how the free-market system of the United States works. And you will learn more about what makes some countries rich and other countries poor. By the end of the chapter, you should understand the direct affect economic systems have on the wealth and happiness of communities throughout the world.

Sources: Don Schwabel, "Stephen Dubner on the Freakonomics Phenomenon," *Forbes,* January 30, 2012; David Futrelle, "The Man Who Made Economics Freaky," *Money Magazine,* June 14, 2010; www.freakonomics.com/about, accessed March 13, 2012; www.stephenjdubner.com/bio.html. accessed March 13, 2012; and www.greatestgood.com, accessed March 13, 2012.

NAME THAT
company

This organization lends small amounts of money to people in poor countries. For example, it loaned a woman in Uganda enough to buy a refrigerator. She was able to sell fresh food from the refrigerator and make enough money for her family to succeed. Name this organization. (The answer is in the chapter.)

LEARNING goal 1

Explain basic economics.

HOW ECONOMIC CONDITIONS AFFECT BUSINESSES

Compared to, say, Mexico, the United States is a relatively wealthy country. Why? Why is South Korea comparatively wealthy and North Korea suffering economically, with many of its people starving?[1] Such questions are part of the subject of economics. In this chapter, we explore the various economic systems of the world and how they either promote or hinder business growth, the creation of wealth, and a higher quality of life for all.

A major part of the United States' business success in the past was due to an economic and social climate that allowed most businesses to operate freely. People were free to start a business anywhere, and just as free to fail and start again. That freedom motivated people to try until they succeeded because the rewards were often so great.[2]

Any change in the U.S. economic or political system has a major influence on the success of the business system. For example, the recent increase in government involvement in business will have an economic effect.[3] What that effect will be in the long run, however, remains to be seen.

Global economics and global politics also have a major influence on businesses in the United States. Therefore, to understand business, you must also understand basic economics and politics. This is especially true of new college graduates looking for jobs.

economics
The study of how society chooses to employ resources to produce goods and services and distribute them for consumption among various competing groups and individuals.

macroeconomics
The part of economics study that looks at the operation of a nation's economy as a whole.

microeconomics
The part of economics study that looks at the behavior of people and organizations in particular markets.

What Is Economics?

Economics is the study of how society chooses to employ resources to produce goods and services and distribute them for consumption among various competing groups and individuals. There are two major branches of economics: **macroeconomics** looks at the operation of a nation's economy as a whole (the whole United States), and **microeconomics** looks at the behavior of people and organizations in markets for particular products or services. A question in macroeconomics might be: What should the United States do to lower its national debt?[4] Macroeconomic topics in this chapter include gross domestic product (GDP), the

The economic contrast is remarkable. Business is booming in Seoul, South Korea (pictured on the left). But North Korea, a communist country, is not doing well, as the picture on the right of thousands of workers using old-fashioned tools in a work-for-food program shows. What do you think accounts for the dramatic differences in the economies of these two neighboring countries?

unemployment rate, and price indexes. A question in microeconomics might be: Why do people buy smaller cars when gas prices go up?

Some economists define economics as the study of the allocation of *scarce* resources. They believe resources need to be carefully divided among people, usually by the government. However, there's no way to maintain peace and prosperity in the world by merely dividing the resources we have today among the existing nations. There aren't enough known resources to do that. **Resource development** is the study of how to increase resources (say, by getting oil and gas from shale and tar sands) and create conditions that will make better use of them (like recycling and conservation).[5]

Businesses can contribute to an economic system by inventing products that greatly increase available resources. For example, they can discover new energy sources (hydrogen fuel for autos), new ways of growing food (hydroponics), and new ways of creating needed goods and services (nanotechnology). Mariculture, or raising fish in pens out in the ocean, could lead to more food for everyone and more employment. It is believed that the United States could monopolize the shrimp industry using aquaculture.[6] Now we import about a billion pounds of shrimp a year.[7] As sustainability remains a high priority in many U.S. industries, some companies try to appear greener than they are. See the nearby Making the Green Connection box for an example.

The Secret to Creating a Wealthy Economy

resource development
The study of how to increase resources and to create the conditions that will make better use of those resources.

Imagine the world when kings and other rich landowners had most of the wealth, and the majority of the people were peasants. The peasants had many children, and it may have seemed a natural conclusion that if things went on as usual there would soon be too many people and not enough food and other resources. Economist

MAKING THE GREEN
connection

www.greenwashingindex.com

It's Not Always Greener

With public concern over the environment at an all-time high, companies are constantly looking for more eco-friendly ways of doing business. Some, however, only want to appear green while still maintaining the same business practices.

These corner-cutting companies have been accused of "greenwashing," or using deceptive marketing and advertising that portray their businesses as environmentally responsible. For example, many paint brands claim to be low in eco-unfriendly volatile organic compounds (VOCs), but when colorant is added to the paint at stores, VOCs are added, too, and the count jumps to dangerous levels. Other products simply offer irrelevant information to appear green, such as aerosol cans with green dots to show the product has no ozone-depleting chlorofluorocarbons (CFCs). In fact, no aerosol spray contains CFCs, because the chemicals were banned in 1978.

Since most greenwashed ads are subtle, they fall short of being illegal and fly under the radar of most consumers. To combat this marketing strategy, independent organizations such as Consumer Reports' greenerchoices.org and the University of Oregon's greenwashingindex.com screen hundreds of ads and determine which are genuinely green and which are greenwashing. For more information, visit these sites, and keep in mind that not everything's as green as it seems.

Sources: Irene Park, "Chicago Shoppers Wary of Green Labeling by Marketers," *Medill Reports Chicago,* March 10, 2011; "Sherwin-Williams Zero-VOC Claim Misleading," *Environmental Building News,* January 21, 2011; and "What Is Greenwashing and How You Can Avoid It," *GreenAnswers.com,* March 4, 2011.

Thomas Malthus made this argument in the late 1700s and early 1800s, leading the writer Thomas Carlyle to call economics "the dismal science."

Followers of Malthus today (who are called neo-Malthusians) still believe there are too many people in the world and that the solution to poverty is radical birth control, including forced abortions and sterilization. The latest world statistics, however, show population growing more slowly than expected. In some industrial countries—like Japan, Germany, Italy, Russia, and the United States—population growth may be so slow that eventually there will be too many old people and too few young people to care for them.[8] In the developing world, on the other hand, population will climb relatively quickly and may lead to greater poverty and more unrest. Studies about the effects of population growth on the economy are part of macroeconomics.

New ways of producing goods and services add resources to the economy and create more employment. Fish farms, for instance, create both food and jobs. Can you think of other innovations that can help increase economic development?

Some macroeconomists believe that a large population, especially an educated one, can be a valuable resource. You've probably heard the saying "Give a man a fish and you feed him for a day, but teach a man to fish and you feed him for a lifetime." You can add to that: "Teach a person to start a fish farm, and he or she will be able to feed a village for a lifetime." *The secret to economic development is contained in this last statement.* Business owners provide jobs and economic growth for their employees and communities as well as for themselves.

The challenge for macroeconomists is to determine what makes some countries relatively wealthy and other countries relatively poor, and then to implement policies and programs that lead to increased prosperity for everyone in all countries. One way to begin understanding this challenge is to consider the theories of Adam Smith.

Adam Smith and the Creation of Wealth

Rather than believing fixed resources had to be divided among competing groups and individuals, Scottish economist Adam Smith envisioned creating more resources so that everyone could become wealthier. Smith's book *An Inquiry into the Nature and Causes of the Wealth of Nations* (often called simply *The Wealth of Nations*) was published in 1776.

Smith believed *freedom* was vital to the survival of any economy, especially the freedom to own land or property and to keep the profits from working the land or running a business.[9] He believed people will work long and hard if they have incentives for doing so—that is, if they know they'll be rewarded. As a result of those efforts, the economy will prosper, with plenty of food and all kinds of products available to everyone.[10] Smith's ideas were later challenged by Malthus and others who believed economic conditions would only get worse, but Smith, not Malthus, is considered the *father of modern economics.*

How Businesses Benefit the Community

In Adam Smith's view, businesspeople don't necessarily deliberately set out to help others. They work primarily for their own prosperity and growth. Yet as people try to improve their own situation in life, Smith said, their efforts serve as an "invisible hand" that helps the economy grow and prosper through the production of needed goods, services, and ideas. Thus, the phrase **invisible hand** is used to describe the process that turns self-directed gain into social and economic benefits for all.

How do people working in their own self-interest produce goods, services, and wealth for others? The only way farmers can become wealthy is to sell some of their crops to others. To become even wealthier, they have to hire workers to produce more food. So the farmers' self-centered efforts to become wealthy lead to jobs for some and food for almost all. Think about that process for a minute, because it is critical

invisible hand
A phrase coined by Adam Smith to describe the process that turns self-directed gain into social and economic benefits for all.

According to Adam Smith's theory, business owners are motivated to work hard because they know they will earn, and keep, the rewards of their labor. When they prosper, as the owner of this restaurant has, they are able to add employees and grow, indirectly helping the community and the larger economy grow in the process. What might motivate you to start your own business?

MAKING ethical decisions

How Corruption Harms the Economy

There are numerous forces in poor countries that hinder economic growth and development. One of those forces is corruption. In many countries, a businessperson must bribe government officials to get permission to own land, build on it, and conduct normal business operations.

The United States has seen much corruption among businesspeople, such as use of prostitutes, illegal drug use, alcohol addiction, and gambling. Imagine you need a permit to add liquor to your restaurant menu to increase your profit. You have tried for years to get one, with no results. You have a friend in the government who offers to help you if you make a large contribution to his or her reelection campaign. Would you be tempted to make a campaign contribution? What are your alternatives? What are the consequences of each?

Sources: Alina Dizik, "Social Concerns Gain New Urgency," *The Wall Street Journal,* March 4, 2010; Carol Loomis, "The $600 Billion Challenge," *Fortune,* July 5, 2010; and Max Bazerman and Ann E. Tenbrunsel, "Ethical Breakdowns," *Harvard Business Review,* April 2011.

to understanding economic growth in the United States and other free countries. The same principles apply to everything from clothing to houses to iPads.

Smith assumed that as people became wealthier, they would naturally reach out to help the less fortunate in the community. That has not always happened. Today, however, many businesspeople are becoming more concerned about social issues and their obligation to return to society some of what they've earned.[11] As we mentioned in Chapter 1, it is important for businesses to be ethical as well as generous. Unethical practices undermine the whole economic system. The Making Ethical Decisions box explores the effects of corruption.

progress assessment

- What is the difference between macroeconomics and microeconomics?
- What is better for an economy than teaching a man to fish?
- What does Adam Smith's term *invisible hand* mean? How does the invisible hand create wealth for a country?

LEARNING goal 2

Explain what capitalism is and how free markets work.

UNDERSTANDING FREE-MARKET CAPITALISM

Basing their ideas on free-market principles such as those of Adam Smith, businesspeople in the United States, Europe, Japan, Canada, and other countries began to create more wealth than ever before. They hired others to work on their farms and in their factories, and their nations began to prosper as a result. Businesspeople soon became the wealthiest people in society.

However, great disparities in wealth remained or even increased. Many businesspeople owned large homes and fancy carriages while most workers lived in humble surroundings. Nonetheless, there was always the promise of better times. One way to be really wealthy was to start a successful business of your own. Of course, it wasn't that easy—it never has been. Then and now, you have to accumulate some money to buy or start a business, and you have to work long hours to make it grow. But the opportunities are there.[12]

The economic system that has led to wealth creation in much of the world is known as capitalism.[13] Under **capitalism** all or most of the factors of production and distribution—such as land, factories, railroads, and stores—are owned by individuals. They are operated for profit, and businesspeople, not government officials, decide what to produce and how much, what to charge, and how much to pay workers. They also decide whether to produce goods in their own countries or have them made in other countries. No country is purely capitalist, however. Often the government gets involved in issues such as determining minimum wages, setting farm prices, and lending money to some failing businesses—as it does in the United States. But capitalism is the *foundation* of the U.S. economic system, and of the economies of England, Australia, Canada, and most other industrialized nations. There have been many suggestions as to how the United States could improve its capitalist system, especially given the recession that began in 2008.[14]

capitalism
An economic system in which all or most of the factors of production and distribution are privately owned and operated for profit.

Some countries are practicing state capitalism. *State capitalism* is where the state runs some businesses instead of private owners. The most obvious example is China, but the same concepts are being used in Russia and some of the Arab nations of the Middle East.[15] These countries have experienced some success using capitalist principles, but the future is still uncertain.[16]

The root word of *capitalism* is "capital." The Connecting with Small Business box shows how a little capital can help small businesses grow in the poorest countries in the world.

The right to own private property and the right to own a business and keep its profits are two of the fundamental rights that exist in the economic system called free-market capitalism. Would either of these rights be viable without the other?

The Foundations of Capitalism

Under free-market capitalism people have four basic rights:

1. *The right to own private property.* This is the most fundamental of all rights under capitalism. Private ownership means that individuals can buy, sell, and use land, buildings, machinery, inventions, and other forms of property. They can also pass property on to their children. Would farmers work as hard if they didn't own the land and couldn't keep the profits from what they earned? More than 90 percent of Egyptians hold their property without legal title. This is one reason they can't build wealth and why they protested in the streets.[17]

2. *The right to own a business and keep all that business's profits.* Recall from Chapter 1 that profits equal revenues minus expenses (salaries, materials, taxes). Profits act as important incentives for business owners.

CONNECTING WITH

small business

www.villagebanking.org

Small Loan, Big Opportunity

One way people in industrialized countries can help people in developing countries is to create a local "bank" that lends money to budding entrepreneurs so they can begin or expand their business. The entrepreneurs must pay the money back, with interest, and often must keep some money in the bank. Such banks don't necessarily have to be in a bank building. Village women often assume the role of banker and decide which women will get the loans. The "bankers" meet in a community building of some sort.

Such banks are sponsored by the Foundation for International Community Assistance (FINCA). In its 10-year history, FINCA has loaned more than $447 million to over 600,000 small-scale entrepreneurs in some of the world's poorest countries. Its borrowers have a 97.6 percent loan repayment rate.

The story of one small entrepreneur will help you understand the process. Pros Magaga lives in Kampala, Uganda. She had a tiny shop in town, but it carried very little inventory. She did not make enough to send her four children to school or to feed them more than once a day. FINCA lent her $50; she used it to buy a refrigerator, which allowed her to carry fresh foods and cold snacks. Later she added a freezer. Now her children are all in school, and the family enjoys two meals a day. Magaga has built a small home with two rooms and plans to add another room soon. She can borrow more money from FINCA because she has already paid back her $50 loan.

Sources: Ruth David, "In a Microfinance Boom, Echoes of Subprime," *Bloomberg Businessweek,* June 21–June 27, 2010; Daniel Fisher, "Bullish on Harare," *Forbes,* November 22, 2010; and "Meet Our Millionth Savings Client," *Impact,* Summer 2012.

3. *The right to freedom of competition.* Within certain guidelines established by the government, individuals are free to compete with other individuals or businesses in selling and promoting goods and services.
4. *The right to freedom of choice.* People are free to choose where they want to work and what career they want to follow. Other choices people are free to make include where to live and what to buy or sell.

One benefit of the four basic rights of capitalism is that people are willing to take more risks than they might otherwise. President Franklin Roosevelt believed four additional freedoms were essential to economic success: freedom of speech and expression, freedom to worship in your own way, freedom from want, and freedom from fear. Do you see the benefits of these additional freedoms?

Now let's explore how the free market works. What role do consumers play in the process? How do businesses learn what consumers need and want? These questions and more are answered next.

How Free Markets Work

A free market is one in which decisions about what and how much to produce are made by the market—by buyers and sellers negotiating prices for goods and services. You and I and other consumers send signals to tell producers what to make, how many, in what color, and so on. We do that by choosing to buy (or not to buy) certain products and services.

For example, if all of us decided we wanted T-shirts supporting our favorite baseball team, the clothing industry would respond in certain ways. Manufacturers and retailers would increase the price of those T-shirts, because they know people are willing to pay more for the shirts they want. They would also realize they could make more money by making more of those T-shirts. Thus, they have an incentive to pay workers to start earlier and end later. Further, the number of companies making T-shirts would increase. How many T-shirts they make depends on how many we request or buy in the stores. Prices and quantities will continue to change as the number of T-shirts we buy changes.

The same process occurs with most other products. The *price* tells producers how much to produce. If something is wanted but isn't available, the price tends to go up until someone begins making more of that product, sells the ones already on hand, or makes a substitute. As a consequence, there's rarely a long-term shortage of goods in the United States.

How Prices Are Determined

In a free market, prices are not determined by sellers; they are determined by buyers and sellers negotiating in the marketplace. A seller may want to receive $50 for a T-shirt, but the quantity buyers demand at that high price may be quite low. If the seller lowers the price, the quantity demanded is likely to increase. How is a price determined that is acceptable to both buyers and sellers? The answer is found in the microeconomic concepts of supply and demand. We shall explore both next.

The Economic Concept of Supply

Supply refers to the quantities of products manufacturers or owners are willing to sell at different prices at a specific time. Generally speaking, the amount supplied will increase as the price increases, because sellers can make more money with a higher price.

Economists show this relationship between quantity supplied and price on a graph. Figure 2.1 shows a simple supply curve for T-shirts. The price of the shirts in dollars is shown vertically on the left of the graph. The quantity of shirts sellers are willing to supply is shown horizontally at the bottom of the graph. The various points on the curve indicate how many T-shirts sellers would provide at different prices. For example, at a price of $5 a shirt, a T-shirt vendor would provide only 5 shirts, but at $50 a shirt the vendor would supply 50 shirts. The supply curve indicates the relationship between the price and the quantity supplied. All things being equal, the higher the price, the more the vendor will be willing to supply.

supply
The quantity of products that manufacturers or owners are willing to sell at different prices at a specific time.

Need help understanding Supply and Demand?
www.introbiz.tv/QR2-1
Can't Scan? Try ScanLife at your app store.

The Economic Concept of Demand

Demand refers to the quantity of products that people are willing to buy at different prices at a specific time. Generally speaking, the quantity demanded will increase as the price decreases. Again, we can show the relationship between price and quantity demanded in a graph. Figure 2.2 shows a simple demand curve for T-shirts. The various points on the graph indicate the quantity demanded at various prices. For example, at $45, buyers demand just 5 shirts, but at $5, the quantity demanded would increase to 35 shirts. All things being equal, the lower the price, the more buyers are willing to buy.

demand
The quantity of products that people are willing to buy at different prices at a specific time.

The Equilibrium Point, or Market Price

You might realize from Figures 2.1 and 2.2 that the key factor in determining the quantities supplied and demanded is *price.* If you were to lay the two graphs one on top of the other, the supply curve and the demand curve would cross where quantity figure 2.1

THE SUPPLY CURVE AT VARIOUS PRICES

The supply curve rises from left to right. Think it through. The higher the price of T-shirts goes (the vertical axis), the more sellers will be willing to supply.

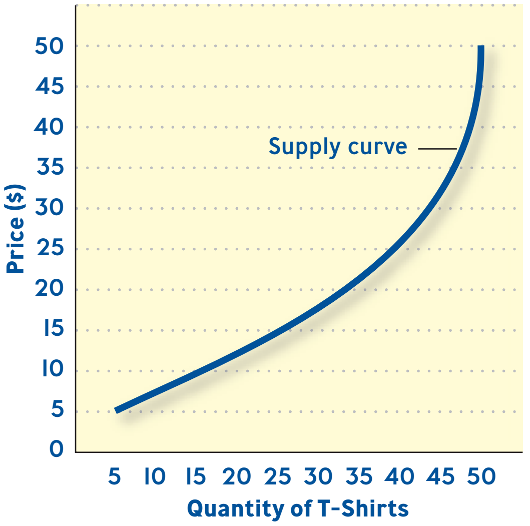


figure 2.2

THE DEMAND CURVE AT VARIOUS PRICES

This is a simple demand curve showing the quantity of T-shirts demanded at different prices. The demand curve falls from left to right. It is easy to understand why. The lower the price of T-shirts, the higher the quantity demanded.

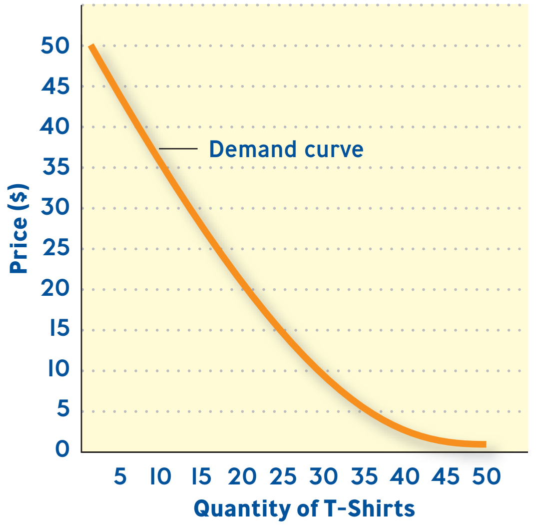
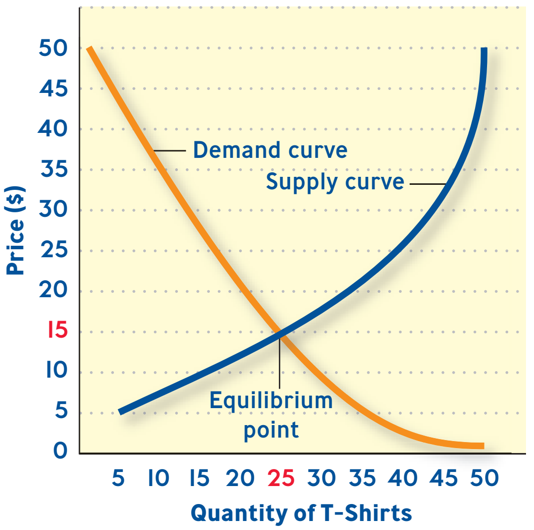


figure 2.3

THE EQUILIBRIUM POINT

The place where quantity demanded and quantity supplied meet is called the equilibrium point. When we put both the supply and demand curves on the same graph, we find that they intersect at a price where the quantity supplied and the quantity demanded are equal. In the long run, the market price will tend toward the equilibrium point.



demanded and quantity supplied are equal. Figure 2.3 illustrates that point. At a price of $15, the quantity of T-shirts demanded and the quantity supplied are equal (25 shirts). That crossing point is known as the *equilibrium point* or *equilibrium price.* In the long run, that price will become the market price. **Market price,** then, is determined by supply and demand. It is the price toward which the market will trend.

Proponents of a free market argue that, because supply and demand interactions determine prices, there is no need for the government to set prices. If quantity supplied exceeds quantity demanded, the resulting surplus signals sellers to lower the price. If shortages develop because the quantity supplied is less than quantity demanded, it signals sellers to increase the price. Eventually, supply will again equal demand if nothing interferes with market forces.

When supplies of oil were lower because of the Gulf oil spill in 2010, for instance, the price of gasoline went up. When supplies were again plentiful, the price of gas fell a little. The price of gas rose again when there was turmoil in the Middle East (e.g., Libya) and the supply of oil was suspect. Note, too, how many alternative fuel sources (wind, solar, tar sands, shale gas, etc.) were tried when the price of gas approached $4 a gallon.[18]

In countries without a free market, there is no mechanism to reveal to businesses (via price) what to produce and in what amounts, so there are often shortages (not enough products)

The economic concept of demand measures the quantities of goods and services that people are willing to buy at a given price. Judging from this photo of people waiting to buy the iPad on the first day it was available for sale, how would you describe the demand for this product? Did the introduction of newer iPads generate similar demand?

or surpluses (too many products). In such countries, the government decides what to produce and in what quantity, but without price signals it has no way of knowing what the proper quantities are. Furthermore, when the government interferes in otherwise free markets, such as when it subsidizes farm goods, surpluses and shortages may develop. Competition differs in free markets, too. We shall explore that concept next.

market price
The price determined by supply and demand.

Competition within Free Markets

Economists generally agree there are four different degrees of competition: (1) perfect competition, (2) monopolistic competition, (3) oligopoly, and (4) monopoly.

Perfect competition exists when there are many sellers in a market and none is large enough to dictate the price of a product. Sellers' products appear to be identical, such as agricultural products like apples, corn, and potatoes. There are no true examples of perfect competition. Today, government price supports and drastic reductions in the number of farms make it hard to argue that even farming represents perfect competition.

perfect competition
The degree of competition in which there are many sellers in a market and none is large enough to dictate the price of a product.

Under **monopolistic competition** a large number of sellers produce very similar products that buyers nevertheless perceive as different, such as hot dogs, sodas, personal computers, and T-shirts. Product differentiation—the attempt to make buyers think similar products are different in some way—is a key to success. Think about what that means. Through advertising, branding, and packaging, sellers try to convince buyers that their products are different from competitors', though they may be very similar or even interchangeable. The fast-food industry, with its pricing battles among hamburger offerings and the like, offers a good example of monopolistic competition.[19]

monopolistic competition
The degree of competition in which a large number of sellers produce very similar products that buyers nevertheless perceive as different.

An **oligopoly** is a degree of competition in which just a few sellers dominate a market, as we see in tobacco, gasoline, automobiles, aluminum, and aircraft. One reason some industries remain in the hands of a few sellers is that the initial

oligopoly
A degree of competition in which just a few sellers dominate the market.

investment required to enter the business often is tremendous. Think, for example, of how much it would cost to start a new airplane manufacturing facility.

In an oligopoly, products from different companies tend to be priced about the same. The reason is simple: Intense price competition would lower profits for everyone, since a price cut by one producer would most likely be matched by the others. As in monopolistic competition, product differentiation, rather than price, is usually the major factor in market success in an oligopoly. Note, for example, that most cereals are priced about the same, as are soft drinks. Thus, advertising is a major factor determining which of the few available brands consumers buy, because often it is advertising that creates the perceived differences.[20]

monopoly
A degree of competition in which only one seller controls the total supply of a product or service, and sets the price.

A **monopoly** occurs when one seller controls the total supply of a product or service, and sets the price. In the United States, laws prohibit the creation of monopolies. Nonetheless, the U.S. legal system has permitted monopolies in the markets for public utilities that sell natural gas, water, and electric power. These companies' prices and profits are usually controlled by public service commissions to protect the interest of buyers. For example, the Florida Public Service Commission is the administering agency over the Florida Power and Light utility company. Legislation ended the monopoly status of utilities in some areas, letting consumers choose among providers. The intention of such *deregulation* is to increase competition among utility companies and, ultimately, lower prices for consumers.

Benefits and Limitations of Free Markets

One benefit of the free market is that it allows open competition among companies. Businesses must provide customers with high-quality products at fair prices with good service. If they don't, they lose customers to businesses that do. Do government services have the same incentives?

The free market—with its competition and incentives—was a major factor in creating the wealth that industrialized countries now enjoy. Some people even talk of the free market as an economic miracle. Free-market capitalism, more than any other economic system, provides opportunities for poor people to work their way out of poverty. Capitalism also encourages businesses to be more efficient so they can successfully compete on price and quality.

Yet, even as free-market capitalism has brought prosperity to the United States and to much of the rest of the world, it has brought inequality as well.[21] Business owners and managers usually make more money and have more wealth than lower-level workers. Yet people who are old, disabled, or sick may not be able to start and manage a business, and others may not have the talent or the drive. What should society do about such inequality? Not everyone in the United States is as generous as Bill Gates, founder of Microsoft, who with his wife has established the Bill and Melinda Gates Foundation to support world health and education.[22] In fact, the desire to create as much wealth as possible has led some businesspeople throughout history, and still today, to exploit such practices as slavery and child labor.

One of the dangers of free markets is that some people let greed dictate how they act. Criminal charges brought against some big businesses in banking, oil, accounting, telecommunications, insurance, and pharmaceuticals indicate the scope of the potential problem. Some businesspeople have deceived the public about their products; others have deceived stockholders about the value of their stock, all in order to increase executives' personal assets.[23]

Clearly, some government laws and regulations are necessary to protect businesses' stakeholders and make sure people who cannot work get the basic care they need.[24] To overcome some of capitalism's limitations, some countries have adopted an economic system called socialism. It, too, has its good and bad points. We explore these after you review the following Progress Assessment questions.

progress assessment

- What are the four basic rights that people have under free-market capitalism?
- How do businesspeople know what to produce and in what quantity?
- How are prices determined?
- What are the four degrees of competition, and what are some examples of each?

socialism
An economic system based on the premise that some, if not most, basic businesses should be owned by the government so that profits can be more evenly distributed among the people.

LEARNING goal 3

Compare socialism and communism.

UNDERSTANDING SOCIALISM

Socialism is an economic system based on the premise that some, if not most, basic businesses (e.g., steel mills, coal mines, and utilities) should be owned by the government so that profits can be more evenly distributed among the people. Entrepreneurs often own and run smaller businesses, and individuals are often taxed relatively steeply to pay for social programs. The top federal personal income tax rate in the United States, for example, was 35 percent recently, but in some socialist countries the top rate can be as much as 60 percent. While U.S. shoppers pay sales taxes ranging from over 10 percent in Chicago to zero in Delaware, socialist countries charge a similar value-added tax of 15 to 20 percent or more. Socialists acknowledge the major benefit of capitalism—wealth creation—but believe that wealth should be more evenly distributed than occurs in free-market capitalism. They believe the government should carry out the distribution and be much more involved in protecting the environment and providing for the poor.

Socialism has been more successful in some countries than in others. This photo shows Denmark's clean and modern public transportation system. In Greece, overspending caused a debt crisis that forced the government to impose austerity measures that many Greeks oppose. What other factors might lead to slower growth in socialist countries?

The Benefits of Socialism

The major benefit of socialism is supposed to be social equality. Ideally it comes about because the government takes income from wealthier people, in the form of taxes, and redistributes it to poorer people through various government programs.[25] Free education through college, free health care, and free child care are some of the benefits socialist governments, using the money from taxes, may provide to their people. Such education benefits helped Finland become the world leader in student achievement.[26] Workers in socialist countries usually get longer vacations, work fewer hours per week, and have more employee benefits (e.g., generous sick leave) than those in countries where free-market capitalism prevails.

The Negative Consequences of Socialism

Socialism may create more equality than capitalism, but it takes away some of businesspeople's incentives. For example, tax rates in some socialist nations once reached 83 percent. Today, doctors, lawyers, business owners, and others who earn a lot of money pay very high tax rates. As a consequence, many of them leave socialist countries for capitalistic countries with lower taxes, such as the United States. This loss of the best and brightest people to other countries is called a **brain drain.**

brain drain
The loss of the best and brightest people to other countries.

Imagine an experiment in socialism in your own class. Imagine that after the first exam, those with grades of 90 and above have to give some of their points to those who make 70 and below so that everyone ends up with grades in the 80s. Would those who got 90s study as hard for the second exam? What about those who got 70s? Can you see why workers may not work as hard or as well if they all get the same benefits regardless of how hard they work?

Socialism also tends to result in fewer inventions and less innovation, because those who come up with new ideas usually don't receive as much reward as they would in a capitalist system. Communism may be considered a more intensive version of socialism. We shall explore that system next.

UNDERSTANDING COMMUNISM

communism
An economic and political system in which the government makes almost all economic decisions and owns almost all the major factors of production.

Communism is an economic and political system in which the government makes almost all economic decisions and owns almost all the major factors of production. It intrudes further into the lives of people than socialism does. For example, some communist countries have not allowed their citizens to practice certain religions, change jobs, or move to the town of their choice.

One problem with communism is that the government has no way of knowing what to produce, because prices don't reflect supply and demand as they do in free markets. The government must guess what the people need. As a result, shortages of many items, including food and clothing, may develop. Another problem is that communism doesn't inspire businesspeople to work hard because the incentives are not there. Therefore, communism is slowly disappearing as an economic form.

Most communist countries today are suffering severe economic depression. In North Korea, many people are starving. In Cuba, people suffer a lack of goods and services readily available in most other countries, and some fear the government.

While some parts of the former Soviet Union remain under communist ideals, Russia itself now has a flat tax of only 13 percent. Yet this low rate increased the government's tax revenues by nearly 30 percent, because more people were willing to pay. The trend toward free markets is growing in Vietnam and parts of China as well. The regions of China that are most free have prospered rapidly, while the rest of the country has grown relatively slowly. Remnants of China's communist system, such as political and religious oppression, still exist, however.

LEARNING goal 4

Analyze the trend toward mixed economies.

THE TREND TOWARD MIXED ECONOMIES

The nations of the world have largely been divided between those that followed the concepts of capitalism and those that adopted the concepts of communism or socialism. We can now contrast the two major economic systems as follows:

1. **Free-market economies** exist when the market largely determines what goods and services get produced, who gets them, and how the economy grows. *Capitalism* is the popular term for this economic system.
2. **Command economies** exist when the government largely decides what goods and services will be produced, who gets them, and how the economy will grow. *Socialism* and *communism* are variations on this economic system.

Since the communist system in Russia has largely collapsed, the country has been moving toward a viable market economy. As poverty begins to decline, a middle class is emerging, but many of the country's vast natural resources are difficult to tap. Laws that help promote business are few, and there is an active black market for many goods. Many observers are optimistic that Russia can prosper. What do you think?

Although all countries actually have some mix of the two systems, neither free-market nor command economies have resulted in optimal economic conditions. Free-market mechanisms don't seem to respond enough to the needs of the poor, the old, or the disabled. Some people also believe that businesses in free-market economies have not done enough to protect the environment. (We shall discuss that issue throughout the text.) Over time, voters in mostly free-market countries, such as the United States, have elected officials who have adopted many social and environmental programs such as Social Security, welfare, unemployment compensation, and various clean air and water acts. What new or enhanced social policies do you know of that are being considered today?

Socialism and communism haven't always created enough jobs or wealth to keep economies growing fast enough. Thus, communist governments are disappearing, and some socialist governments have been cutting back on social programs and lowering taxes on businesses and workers to generate more business growth and more revenue.[27]

The trend, then, has been for mostly capitalist countries (like the United States) to move toward socialism (i.e., more government involvement in health care), and for some socialist countries to move toward capitalism (more private businesses, lower taxes). All countries have some mix of the two systems. Thus, the long-term global trend is toward a blend of capitalism and socialism. This trend likely will increase with the opening of global markets made easier by the Internet. The net effect is the emergence throughout the world of mixed economies (see the Connecting Across Borders box).

Mixed economies exist where some allocation of resources is made by the market and some by the government. Most countries don't have a name for such a system. If free-market mechanisms allocate most resources, the leaders call their system capitalism. If the government allocates most resources, the leaders call it socialism. Figure 2.4 compares the various economic systems.

free-market economies
Economic systems in which the market largely determines what goods and services get produced, who gets them, and how the economy grows.

command economies
Economic systems in which the government largely decides what goods and services will be produced, who will get them, and how the economy will grow.

mixed economies
Economic systems in which some allocation of resources is made by the market and some by the government.

CONNECTING ACROSS

borders

www.img.org

Africa's Evolving Economy

For much of the 20th century, stories about Africa's economy inevitably focused on the continent's rampant poverty. The end of colonial rule in Africa brought military dictatorships and other oppressive forces to power in many countries. Coupled with disease and an almost nonexistent infrastructure, Africa's economy and its people suffered horribly.

Thankfully, the 21st century has been brighter for many Africans. A booming commodities market along with expanding manufacturing and service economies are leading to unprecedented growth. Over the last decade, six of the world's 10 fastest-growing countries were African. In eight of those years, Africa has even outpaced the growth of East Asia, including Japan. The International Monetary Fund estimated that the African economy would grow by 6 percent by the end of 2012 and further expand by the same amount in 2013.

Much of this economic expansion has happened thanks to the manufacturing might of countries like South Africa. With the largest economy on the continent, South Africa finished 2011's final quarter with a 3.2 percent growth in GDP. Even small, formerly war-torn nations are now experiencing economic improvements. For instance, in the 1990s Rwanda suffered a horrific civil war and genocide that claimed the lives of hundreds of thousands of citizens. Subsequent years of peace and a relatively stable government have since turned the country around significantly. Unlike many African nations, Rwandan businesses face little corruption and enjoy ever-improving infrastructure. Although skilled labor is in short supply in Rwanda and other emerging nations, population growth is set to double in the coming years. Experts hope that this younger generation will take advantage of improving educational opportunities and ensure Africa's place on the global economic stage.

Sources: Andres R. Martinez, "South African Economy Expands 3.2% as Manufacturing Rebounds," *Bloomberg Businessweek,* February 28, 2012; "Business in Rwanda: Africa's Singapore?" *The Economist,* February 25, 2012; and "The Hopeful Continent: Africa Rising," *The Economist,* December 3, 2011.

Like most other nations of the world, the United States has a mixed economy. The U.S. government has now become the largest employer in the country, which means there are more workers in the public sector (government) than in any of the major businesses in the United States. Do you see the government growing or declining in the coming years?

progress assessment

- What led to the emergence of socialism?
- What are the benefits and drawbacks of socialism?
- What countries still practice communism?
- What are the characteristics of a mixed economy?

LEARNING goal 5

Describe the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.

	CAPITALISM* (United States)	SOCIALISM (Sweden)	COMMUNISM (North Korea)	MIXED ECONOMY (Germany)
Social and Economic Goals	Private ownership of land and business. Liberty and the pursuit of happiness. Free trade. Emphasis on freedom and the profit motive for economic growth.	Public ownership of major businesses. Some private ownership of smaller businesses and shops. Government control of education, health care, utilities, mining, transportation, and media. Very high taxation. Emphasis on equality.	Public ownership of all businesses. Government-run education and health care. Emphasis on equality. Many limitations on freedom, including freedom to own businesses and to assemble to protest government actions.	Private ownership of land and business with government regulation. Government control of some institutions (e.g., mail). High taxation for defense and the common welfare. Emphasis on a balance between freedom and equality.
Motivation of Workers	Much incentive to work efficiently and hard because profits are retained by owners. Workers are rewarded for high productivity.	Capitalist incentives exist in private businesses. Government control of wages in public institutions limits incentives.	Very little incentive to work hard or to produce quality goods or services.	Incentives are similar to capitalism except in government-owned enterprises, which may have fewer incentives.
Control over Markets	Complete freedom of trade within and among nations. Some government control of markets.	Some markets are controlled by the government and some are free. Trade restrictions among nations vary and include some free-trade agreements.	Total government control over markets except for illegal transactions.	Some government control of trade within and among nations (trade protectionism).
Choices in the Market	A wide variety of goods and services is available. Almost no scarcity or over-supply exists for long because supply and demand control the market.	Variety in the marketplace varies considerably from country to country. Choice is directly related to government involvement in markets.	Very little choice among competing goods.	Similar to capitalism, but scarcity and oversupply may be caused by government involvement in the market (e.g., subsidies for farms).
Social Freedoms	Freedom of speech, press, assembly, religion, job choice, movement, and elections.	Similar to mixed economy. Governments may restrict job choice, movement among countries, and who may attend upper-level schools (i.e., college).	Very limited freedom to protest the government, practice religion, or change houses or jobs.	Some restrictions on freedoms of assembly and speech. Separation of church and state may limit religious practices in schools.

*The United States is a mixed economy based on a foundation of capitalism.

figure 2.4

COMPARISONS OF KEY ECONOMIC SYSTEMS

UNDERSTANDING THE U.S. ECONOMIC SYSTEM

The following sections will introduce the terms and concepts that you, as an informed citizen, will need to understand in order to grasp the issues facing government and business leaders in the United States.

Need help understanding Basic Economic Systems? www.introbiz.tv/QR2-2

Key Economic Indicators

Three major indicators of economic conditions are (1) the gross domestic product (GDP), (2) the unemployment rate, and (3) price indexes. Another important statistic is the increase or decrease in productivity. When you read business literature, you'll see these terms used again and again. Let's explore what they mean.

gross domestic product (GDP) The total value of final goods and services produced in a country in a given year.

unemployment rate The number of civilians at least 16 years old who are unemployed and tried to find a job within the prior four weeks.

Gross Domestic Product

Gross domestic product (GDP), which we mentioned briefly in Chapter 1, is the total value of final goods and services produced in a country in a given year. Both domestic and foreign-owned companies can produce the goods and services included in GDP, as long as the companies are located within the country's boundaries. For example, production values from Japanese automaker Honda's factory in Ohio are included in U.S. GDP. Revenue generated by Ford's factory in Mexico is included in Mexico's GDP, even though Ford is a U.S. company.

Almost every discussion about a nation's economy is based on GDP. If growth in GDP slows or declines, businesses may feel many negative effects, such as the slowdown in retail sales experienced beginning in 2008. A major influence on the growth of GDP is the productivity of the workforce—that is, how much output workers create with a given amount of input. The total U.S. GDP is over $14 trillion. The level of U.S. economic activity is actually larger than the GDP figures show, because those figures don't take into account illicit activities such as sales of illegal drugs. The high GDP in the United States is what enables its citizens to enjoy a high standard of living.

The overall unemployment rate in the United States fluctuates. Over the last decade, it has been as low as less than 5 percent and as high as more than 10 percent. Unemployment insurance goes only so far to relieve the loss of income caused by losing your job. How high is the unemployment rate in your area today?

The Unemployment Rate

The **unemployment rate** refers to the percentage of civilians at least 16 years old who are unemployed *and tried to find a job within the prior four weeks.* In 2000, the U.S. unemployment rate reached its lowest point in over 30 years, falling as low as 3.9 percent, but by 2010 the rate had risen to over 9.5 percent (see Figure 2.5). The unemployment rate fell to about 8 percent in 2012, but many people had given up looking for jobs (people who are not actively looking for work are not included in the unemployment figures).[28]

Figure 2.6 describes the four types of unemployment: frictional, structural, cyclical, and seasonal. The United States tries to protect those who are unemployed because of recessions (defined later in the chapter), industry shifts, and other cyclical factors. Nonetheless, the *underemployment* figure in 2012 was about 17 percent (this includes those who are working part time and want to work full time and those who stopped looking for work).

If you worry about the U.S. unemployment rate, consider this: the unemployment rate in Zimbabwe was way over 80 percent, and the inflation rate was

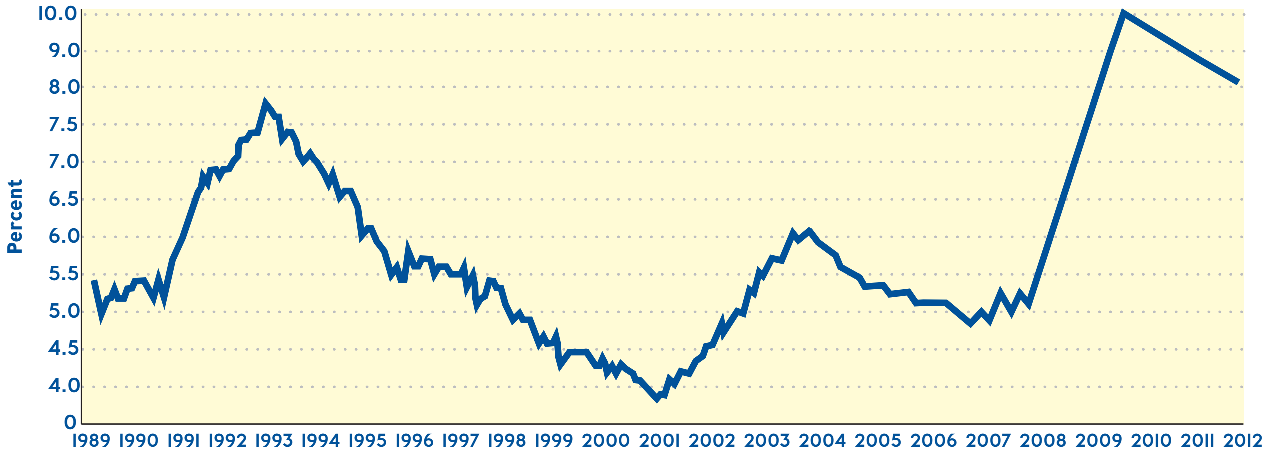


figure 2.5

U.S. UNEMPLOYMENT RATE 1989–2012

spectacular. You would have enjoyed cashing in your dollars in Zimbabwe; one dollar got you billions of Zimbabwean dollars. Actually, the situation got much worse. Do you suppose Zimbabwe is a capitalist economy?

Inflation and Price Indexes Price indexes help gauge the health of the economy by measuring the levels of inflation, disinflation, deflation, and stagflation. **Inflation** is a general rise in the prices of goods and services over time. The official definition is "a persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of goods and services." Thus, it is also described as "too many dollars chasing too few goods." Go back and review the laws of supply and demand to see how that works. Rapid inflation is scary. If the prices of goods and services go up by just 7 percent a year, they will double in about 10 years. Think of how much fear was generated by the rapid increase in the price of gasoline in 2011 to early 2012.

Disinflation occurs when price increases are slowing (the inflation rate is declining). That was the situation in the United States throughout the 1990s. **Deflation** means that prices are declining.[29] It occurs when countries produce so

inflation
A general rise in the prices of goods and services over time.

disinflation
A situation in which price increases are slowing (the inflation rate is declining).

deflation
A situation in which prices are declining.

- *Frictional unemployment* refers to those people who have quit work because they didn't like the job, the boss, or the working conditions and who haven't yet found a new job. It also refers to those people who are entering the labor force for the first time (e.g., new graduates) or are returning to the labor force after significant time away (e.g., parents who reared children). There will always be some frictional unemployment because it takes some time to find a first job or a new job.
- *Structural unemployment* refers to unemployment caused by the restructuring of firms or by a mismatch between the skills (or location) of job seekers and the requirements (or location) of available jobs (e.g., coal miners in an area where mines have been closed).
- *Cyclical unemployment* occurs because of a recession or a similar downturn in the business cycle (the ups and downs of business growth and decline over time). This type of unemployment is the most serious.
- *Seasonal unemployment* occurs where demand for labor varies over the year, as with the harvesting of crops.

figure 2.6

FOUR TYPES OF UNEMPLOYMENT

stagflation
A situation when the economy is slowing but prices are going up anyhow.

consumer price index (CPI)
Monthly statistics that measure the pace of inflation or deflation.

producer price index (PPI)
An index that measures prices at the wholesale level.

many goods that people cannot afford to buy them all (too few dollars are chasing too many goods). **Stagflation** occurs when the economy is slowing but prices are going up anyhow. Some economists fear the United States may face stagflation in the near future.[30]

The **consumer price index (CPI)** consists of monthly statistics that measure the pace of inflation or deflation. The government computes costs of goods and services—including housing, food, apparel, and medical care—to see whether they are going up or down (see Figure 2.7). The CPI is an important figure because some wages and salaries, rents and leases, tax brackets, government benefits, and interest rates are based on it. You may see the term *core inflation.* That means the CPI minus food and energy costs. Since food and energy have been going up rapidly, the core inflation figure is actually much lower than the real CPI.

The **producer price index (PPI)** measures prices at the wholesale level. Other indicators of the economy's condition include housing starts, retail sales, and changes in personal income. You can learn more about such indicators by reading business periodicals, listening to business broadcasts on radio and television, and exploring business sites on the Internet.

Productivity in the United States

An increase in productivity means a worker can produce more goods and services than before in the same time period, usually thanks to machinery or other equipment. Productivity in the United States has risen because computers and other technology have made production faster and easier. The higher productivity is, the lower the costs are of producing goods and services, and the lower prices can be. Therefore, businesspeople are eager to increase productivity. Remember, however, that high productivity can lead to high unemployment.[31] Certainly, that is what the United States in now experiencing.

Now that the U.S. economy is a service economy, productivity is an issue because service firms are so labor-intensive. Spurred by foreign competition, productivity in the manufacturing sector is rising rapidly. In the service sector, productivity is growing more slowly because service workers—like teachers, clerks, lawyers, and barbers—have fewer new technologies available than there are for factory workers.

Productivity in the Service Sector

One problem with the service industry is that an influx of machinery may add to the *quality* of the service provided but not to the *output per worker.* For example, you've probably noticed how many computers there are on college campuses. They add to the quality of education but don't necessarily boost professors' productivity. The

figure 2.7

HOW THE CONSUMER PRICE INDEX IS PUT TOGETHER

1. 400 data collectors visit stores and gather 80,000 retail price quotes and 5,000 housing rent quotes, transmitting data daily to Washington.
2. 40 commodity analysts at the Bureau of Labor Statistics review about a quarter of this avalanche of price data.
3. About nine days before the release of the CPI, the office is locked down—with bright red RESTRICTED AREA signs posted on all the doors.
4. 90 people—a mix of commodity analysts and other economists who specialize in assembling the CPI—compute basic indexes for 211 item categories, which are divided into 38 index areas.
5. Final results are released at 8:30 a.m., Eastern time, about two weeks after the end of the month in question.

same is true of some equipment in hospitals, such as CAT scanners, PET scanners, and MRI scanners. They improve patient care but don't necessarily increase the number of patients doctors can see. In other words, today's productivity measures in the service industry fail to capture the increase in quality caused by new technology.

Clearly, the United States and other countries need to develop new measures of productivity for the service economy that include quality as well as quantity of output. Despite productivity improvement, the economy is likely to go through a series of ups and downs, much as it has over the past few years. We'll explore that process next.

It can be difficult to measure productivity in the service sector. New technology can improve the quality of services without necessarily increasing the number of people served. A doctor can make more-accurate diagnoses with scans, for instance, but still can only see so many patients in a day. How can productivity measures capture improvements in the quality of service?

The Business Cycle

Business cycles are the periodic rises and falls that occur in economies over time. Economists look at a number of business cycles, from seasonal cycles that occur within a year to cycles that occur every 48–60 years.

Economist Joseph Schumpeter identified the four phases of long-term business cycles as boom–recession–depression–recovery:

1. An *economic boom* is just what it sounds like—business is booming.
2. **Recession** is two or more consecutive quarters of decline in the GDP. In a recession prices fall, people purchase fewer products, and businesses fail. A recession brings high unemployment, increased business failures, and an overall drop in living standards. The recession that started in 2008 is an example.
3. A **depression** is a severe recession, usually accompanied by deflation. Business cycles rarely go through a depression phase. In fact, while there were many business cycles during the 20th century, there was only one severe depression (1930s). Nonetheless some economists are predicting a depression in the coming years.
4. A *recovery* occurs when the economy stabilizes and starts to grow. This eventually leads to an economic boom, starting the cycle all over again.

One goal of some economists is to predict such ups and downs. That is very difficult to do. Business cycles are identified according to facts, but we can explain those facts only by using theories. Therefore, we cannot predict with certainty. But one thing is certain: over time, the economy *will* rise and fall as it has done lately.

Since dramatic swings up and down in the economy cause all kinds of disruptions to businesses, the government tries to minimize such changes. It uses fiscal policy and monetary policy to try to keep the economy from slowing too much or growing too rapidly.

business cycles
The periodic rises and falls that occur in economies over time.

recession
Two or more consecutive quarters of decline in the GDP.

depression
A severe recession, usually accompanied by deflation.

LEARNING goal 6

Contrast fiscal policy and monetary policy, and explain how each affects the economy.

Stabilizing the Economy through Fiscal Policy

fiscal policy
The federal government's efforts to keep the economy stable by increasing or decreasing taxes or government spending.

Fiscal policy refers to the federal government's efforts to keep the economy stable by increasing or decreasing taxes or government spending.[32] The first fiscal policy tool is taxation. Theoretically, high tax rates tend to slow the economy because they draw money away from the private sector and put it into the government. High tax rates may discourage small-business ownership because they decrease the profits businesses can earn and make the effort less rewarding. It follows, then, that low tax rates will theoretically give the economy a boost. When you count all fees, sales taxes, and more, taxes on the highest-earning U.S. citizens could exceed 50 percent. Is that figure too high or not high enough in your opinion? Why?

The second fiscal policy tool is government spending on highways, social programs, education, infrastructure (e.g., roads and utilities), defense, and so on. The *national deficit* is the amount of money the federal government spends beyond what it gathers in taxes for a given fiscal year. The deficit is expected to be over $1 trillion for the next several years. Such deficits increase the national debt. The **national debt** is the sum of government deficits over time. Recently, the national debt was over $16 trillion (see Figure 2.8). That is a rather misleading number, however, since the unfunded obligation for Medicare alone is over $34 trillion. The unfunded debt to Social Security is on top of that. If the government takes in more revenue than it spends (i.e., tax revenues exceed expenditures), there is a *national surplus.* That is not likely to happen soon.

national debt
The sum of government deficits over time.

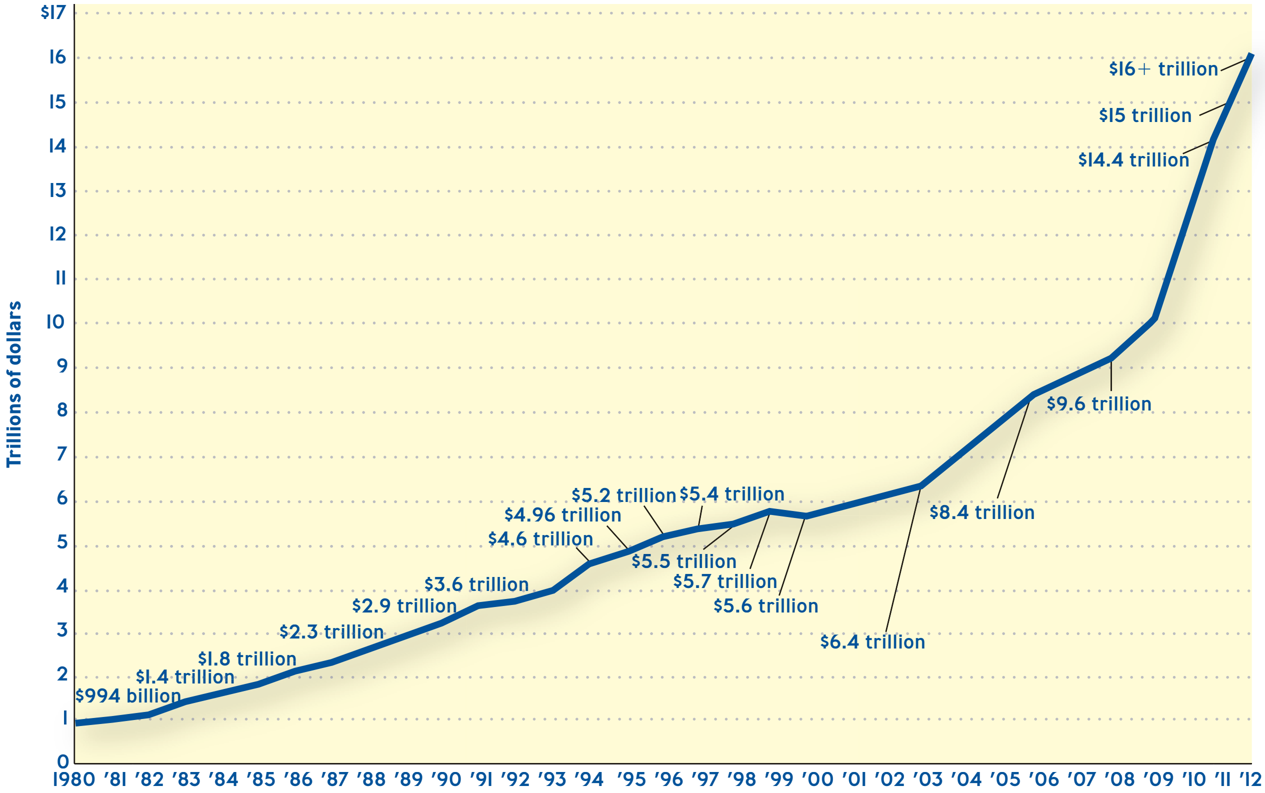


figure 2.8

THE NATIONAL DEBT

One way to lessen deficits is to cut government spending. Many presidents and those in Congress have promised to make the government "smaller," that is, to reduce government spending—but that doesn't happen very often. There seems to be a need for more social programs or more defense spending (such as for the wars in Iraq, Afghanistan, and Libya) each year, and thus the deficits continue and add to the national debt. Some people believe that government spending helps the economy grow. Others believe that the money the government spends comes out of the pockets of consumers and businesspeople, and thus slows growth. What do you think?

The economic crisis beginning in 2008 caused much anguish among Wall Street workers and people in general. How effective was the government's response?

Fiscal Policy in Action during the Economic Crisis That Began in 2008

For most of his presidency, George W. Bush followed the basic economic principles of free markets. By the end of his term, however, the economy was facing a dire economic crisis and President Bush approved the spending of almost $1 trillion of government money in an effort to revive the failing economy (including helping out banks, the auto industry, and others). (A trillion dollars is about $3,272 per person in the United States.) President Barack Obama promised to spend additional funds. Both presidents were following the basic economic theory of John Maynard Keynes.[33] **Keynesian economic theory** is the theory that a government policy of increasing spending and cutting taxes could stimulate the economy in a recession.

Using Monetary Policy to Keep the Economy Growing

Have you ever wondered what organization adds money to or subtracts money from the economy? The answer is the Federal Reserve Bank (the Fed). The Fed is a semiprivate organization that is not under the direct control of the government but does have members appointed by the president. We will discuss the Fed in detail when we look at banking in Chapter 20. Now we simply introduce monetary policy and the role of the Fed in controlling the economy.

Monetary policy is the management of the money supply and interest rates by the Federal Reserve Bank. The Fed's most visible role is the raising and lowering of interest rates. When the economy is booming, the Fed tends to raise interest rates. This makes money more expensive to borrow. Businesses thus borrow less, and the economy slows as businesspeople spend less money on everything they need to grow, including labor and machinery. The opposite is true when the Fed lowers interest rates. Businesses tend to borrow more, and the economy is expected to grow. Raising and lowering interest rates should therefore help control the rapid ups and downs of the economy.[34] In 2010–2012, the Fed kept interest rates near zero, but the economy remained sluggish. You can imagine the pressure that put on the head of the Federal Reserve.[35]

The Fed also controls the money supply. A simple explanation of this function is that the more money the Fed makes available to businesspeople and others, the

Keynesian economic theory
The theory that a government policy of increasing spending and cutting taxes could stimulate the economy in a recession.

monetary policy
The management of the money supply and interest rates by the Federal Reserve.

faster the economy is supposed to grow. To slow the economy (and prevent inflation), the Fed lowers the money supply. The Fed poured money into the economy in 2008–2012. What would you expect the result to be?

To sum up, there are two major tools for managing the economy of the United States: fiscal policy (government taxes and spending) and monetary policy (the Fed's control over interest rates and the money supply). The goal is to keep the economy growing so that more people can rise up the economic ladder and enjoy a higher standard of living and quality of life.

progress assessment

- Name the three economic indicators and describe how well the United States is doing based on each indicator.
- What's the difference between a recession and a depression?
- How does the government manage the economy using fiscal policy?
- What does the term *monetary policy* mean? What organization is responsible for monetary policy?

summary

Learning Goal 1. Explain basic economics.

- **What is economics?**

  Economics is the study of how society chooses to employ resources to produce goods and services and distribute them for consumption among various competing groups and individuals.

- **What are the two branches of economics?**

  There are two major branches of economics: macroeconomics studies the operation of a nation's economy as a whole, and microeconomics studies the behavior of people and organizations in particular markets (e.g., why people buy smaller cars when gas prices go up).

- **How can we be assured of having enough resources?**

  Resource development is the study of how to increase resources and create the conditions that will make better use of them.

- **How does capitalism create a climate for economic growth?**

  Under capitalism, businesspeople don't often deliberately set out to help others; they work mostly for their own prosperity and growth. Yet people's efforts to improve their own situation in life act like an *invisible hand* to help the economy grow and prosper through the production of needed goods, services, and ideas.

Learning Goal 2. Explain what capitalism is and how free markets work.

- **What is capitalism?**

  Capitalism is an economic system in which all or most of the means of production and distribution are privately owned and operated for profit.

- **Who decides what to produce under capitalism?**

  In capitalist countries, businesspeople decide what to produce, how much to pay workers, and how much to charge for goods and services. They also decide whether to produce certain goods in their own countries, import those goods, or have them made in other countries.

- **What are the basic rights people have under capitalism?**

  The four basic rights under capitalism are (1) the right to own private property, (2) the right to own a business and to keep all of that business's profits after taxes, (3) the right to freedom of competition, and (4) the right to freedom of choice. President Franklin D. Roosevelt felt that other economic freedoms were also important: the right to freedom of speech and expression, the right to worship in your own way, and freedom from want and fear.

- **How does the free market work?**

  The free market is one in which buyers and sellers negotiating prices for goods and services influence the decisions about what gets produced and in what quantities. Buyers' decisions in the marketplace tell sellers what to produce and in what quantity. When buyers demand more goods, the price goes up, signaling suppliers to produce more. The higher the price, the more goods and services suppliers are willing to produce. Price is the mechanism that allows freema rketstow ork.

Learning Goal 3. Compare socialism and communism.

- **What is socialism?**

  Socialism is an economic system based on the premise that some businesses should be owned by the government.

- **What are the advantages and disadvantages of socialism?**

  Socialism intends to create more social equity. Workers in socialist countries usually receive more education, health care, and other benefits and also work fewer hours, with longer vacations. The major disadvantage of socialism is that it lowers the incentive to start a business or to work hard. Socialist economies tend to have a higher unemployment rate and a slower growth rate than capitalist economies.

- **How does socialism differ from communism?**

  Under communism, the government owns almost all major production facilities and dictates what gets produced and by whom. Communism is also more restrictive when it comes to personal freedoms, such as religious freedom.

Learning Goal 4. Analyze the trend toward mixed economies.

- **What is a mixed economy?**

  A mixed economy is part capitalist and part socialist. Some businesses are privately owned, but taxes tend to be high to distribute income more evenly among the population.

- **What countries have mixed economies?**

  The United States has a mixed economy, as do most other industrialized countries.

- **What are the benefits of mixed economies?**

  A mixed economy has most of the benefits of wealth creation that free markets bring plus the benefits of greater social equality and concern for the environment that socialism promises.

Learning Goal 5. Describe the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.

- **What are the key economic indicators in the United States?**

Gross domestic product (GDP) is the total value of final goods and services produced in a country in a given year. The *unemployment rate* refers to the percentage of civilians at least 16 years old who are unemployed and tried to find a job within the most recent four weeks. The *consumer price index (CPI)* measures changes in the prices of about 400 goods and services that consumersbuy .

- **What are the four phases of business cycles?**

In an *economic boom,* businesses do well. A *recession* occurs when two or more quarters show declines in the GDP, prices fall, people purchase fewer products, and businesses fail. A *depression* is a severe recession. *Recovery* occurs when the economy stabilizes and starts to grow.

Learning Goal 6. Contrast fiscal policy and monetary policy, and explain how each affects the economy.

- **What is fiscal policy?**

Fiscal policy consists of government efforts to keep the economy stable by increasing or decreasing taxes or government spending.

- **What is the importance of monetary policy to the economy?**

Monetary policy is the management of the money supply and interest rates. When unemployment gets too high, the Federal Reserve Bank (the Fed) may put more money into the economy and lower interest rates. That is supposed to provide a boost to the economy as businesses borrow and spend more money and hire more people.

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critical thinking

The U.S. Supreme Court ruled that cities could have school voucher programs that give money directly to parents, who could then choose between competing schools, public or private. The idea was to create competition among schools. Like businesses, schools were expected to improve their services (how effectively they teach) to win students from competitors. The result would be improvement in all schools, private and public, to benefit many students.

1. Do you believe economic principles like competition apply in both private and public organizations? Be prepared to defend your answer.
2. Are there other public functions that might benefit from more competition, including competition from private firms?
3. Many people say that businesspeople do not do enough for society. Some students choose to go into the public sector instead of business because they want to help others. However, businesspeople say that they do more to help others than nonprofit groups do because they provide jobs for people rather than giving them charity. Furthermore, they believe businesses create all the wealth that nonprofit groups distribute.
    a. How can you find some middle ground in this debate to show that both businesspeople and those who work for nonprofit organizations contribute to society and need to work together more closely to help people?
    b. How could you use the concepts of Adam Smith to help illustrate your position?

developing workplace skills

1. In teams, develop a list of the advantages of living in a capitalist society. Then develop lists headed "What are the disadvantages?" and "How could such disadvantages be minimized?" Describe why a poor person in a socialist country might reject capitalism and prefer a socialist state.
2. Show your understanding of the principles of supply and demand by looking at the oil market today. Why does the price of gas fluctuate so greatly? What will happen as more and more people in China and India decide to buy automobiles? What would happen if most U.S. consumers decided to drive electric cars?
3. This exercise will help you understand socialism from different perspectives. Form three groups. Each group should adopt a different role in a socialist economy: one group will be the business owners, another group will be workers, and another will be government leaders. Within your group discuss and list the advantages and disadvantages to you of lowering taxes on businesses. Then have each group choose a representative to go to the front of the class and debate the tax issue with the representatives from the other groups.
4. Draw a line and mark one end "Free-Market Capitalism" and the other end "Central Planning." Mark where on the line the United States is now. Explain why you marked the spot you chose. Students from other countries may want to do this exercise for their own countries and explain the differences to the class.

5. Break into small groups. In your group discuss how the following changes have affected people's purchasing behavior and attitudes toward the United States and its economy: the wars in Iraq and Afghanistan, the increased amount spent on homeland security, the government involvement in banking and other industries, and the growth of the Internet. Have a group member prepare a short summary for the class.

taking it to the net

Purpose

To familiarize you with the sources of economic information that are important to business decision makers.

Exercise

Imagine that your boss asked you to help her to prepare the company's sales forecast for the coming two years. In the past, she felt that trends in the nation's GDP, U.S. manufacturing, and manufacturing in Illinois were especially helpful in forecasting sales. She would like you to do the following:

1. Go to the Bureau of Economic Analysis's website (**www.bea.gov**) and locate the gross domestic product data. Compare the annual figure for the last four years. What do the figures indicate for the next couple of years?
2. At the Bureau of Labor Statistics' website (**www.bls.gov**) under Industries, click on Industries at a Glance to find the information about the manufacturing industry. What is the employment trend in manufacturing over the last four years (percentage change from preceding period)?
3. Return to the Bureau of Labor Statistics' home page and use the Search feature to find trends in employment for the state of Illinois. Look around the website to see what other information is available. Plot the trend in manufacturing employment in Illinois over the last four years. On your own, discuss what economic changes may have influenced that trend.
4. Based on the information you have gathered, write a brief summary of what may happen to company sales over the next couple of years.

casing the web

To access the case "The Rule of 72," visit **www.mhhe.com/P2P2e**

video case

Connect BUSINESS

Opportunity International: Giving the Poor a Working Chance

Billions of people in the world make $2 a day or less. In fact, a billion people make less than $1 a day. In such places, a loan of $100 or $200 makes a huge difference. That's where microloans from organizations such as Opportunity International come in.

Opportunity International is an organization that grants microloans to people, mostly women, in developing countries so they can invest in a business. Those investments often lead to community growth and employment, and help the owners themselves to prosper on a moderate scale. The borrowers must pay back the money with interest—when they do, they can borrow more and keep growing. Opportunity International, unlike some other microlending organizations, also provides a banking function where entrepreneurs can safely put their money. They can also buy some insurance to protect themselves against loss.

Opportunity International helps over a million people in over 28 countries, giving them the opportunity to change their lives for the better. This video introduces you to some of those people, but primarily explains how freedom and a little money can combine to create huge differences in people's lives.

Adam Smith was one of the first people to point out that wealth comes from freedom, the ability to own land, and the ability to keep the profits from what you do on that land. When people try to maximize profits, they have to hire other people to help them do the work. This provides jobs for others and wealth for the entrepreneur. And, like an invisible hand, the whole community benefits from the entrepreneurs' desire to earn a profit. In the video, you can see a woman in Uganda who has applied those principles to benefit her family, provide employment, and help her community.

Free-market capitalism is the system where people can own their own land and businesses and keep the profits they earn. Such a system demands that people can (1) own their own property (not a reality in many developing nations); (2) keep the profits from any business they start; (3) compete with other businesses (it is difficult to compete with the government); and (4) work wherever and whenever they want. The key word in capitalism is *freedom*—freedom of religion, freedom to own land, and freedom to prosper and grow. Opportunity International is making an attempt to show people how freedom plus a few dollars can make a huge difference in an economy.

In a free-market economy, price is determined by buyers and sellers negotiating over the price of a good or service. The equilibrium point is the place where buyers and sellers agree to an exchange; it is also called the market price. Without free markets, there is no way of knowing what buyers need and what sellers need to produce. Thus, in command economies, where there is no supply-and-demand mechanism in operation, there can be shortages or surpluses in food, clothing, and other necessities.

Socialism and communism are alternatives to a free-market economy. Under such systems, people are more likely to have a bit of equality, but there are fewer incentives to work hard, and entrepreneurs are often lured to countries where they can make more money by working harder. The result is called a brain drain, where the best and the brightest often move to free-market countries. There are advantages to socialism and communism, such as free schools, free health care, free day care, etc. But the taxes are higher, and there is usually less innovation and higher unemployment.

The trend in the world is toward mixed economies, where most of the economy is based on free-market principles, but the government gets involved in things such as education, health care, and welfare. The United States has been basically a free-market economy, but it is clear that there is a movement toward more government involvement. On the other hand, some countries are reducing the role of government in society and moving toward freer markets. Thus the world is moving toward mixed economies.

The United States government tries to control the money supply through the Federal Reserve and fiscal policy. Fiscal policy has to do with taxes and spending. The less the government spends, the more that is available for businesses to invest. And the lower the tax rates on entrepreneurs, the more they will invest in businesses and the faster the economy will grow.

Opportunity International shows the poorest of the poor how important entrepreneurs, freedom, opportunity, and a little bit of money are to economic growth and prosperity. You are encouraged in this video to participate in helping poor people around the world. You can do this by contributing time and money to organizations like Opportunity International. You can join the Peace Corps or other groups designed to assist less-developed countries.

Thinking It Over

1. *Why is there a need for organizations like Opportunity International? Can't poor people get loans from banks and other sources?*
2. *Identify the four major requirements necessary for a free-market system to operate.*
3. *What is the main difference between capitalism and a mixed economy? Which model is used in the United States?*