HOW economics affects business

The Creation and Distribution of Wealth

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profile

Getting to Know

Hernando de Soto,

Economist for the Poor

Crowded together, eager fans push to get a glimpse of a celebrity visiting a poor community in Peru. Who is this person who has the town so excited? A rock singer, a famous athlete, a movie star? No. Would you believe an economist? Hernando de Soto, a noted economist, wrote one of Peru's best-selling books, and the crowds were eager to hear his ideas about improving the country's economy—and thus their own lives.

Hernando de Soto was born in Peru. He went on to study in Canada, the United States, and Switzerland. Eventually he got a graduate degree in international economics and law at the University of Geneva. He was successful enough to become managing director of Universal Engineering Corporation, a Swiss consulting firm. He made enough money to retire but decided instead to devote his time to studying what makes some countries rich and others poor. He returned to Peru and studied the entrepreneurs there to see what held them back. What he learned was that the business owners were locked out of the formal, legal economy because there were no laws that provided property titles. That is, people could have houses, but no titles to them; farms, but no deeds to them; and businesses, but no certificates of incorporation. The lack of formal titling prevented owners from using their property as collateral, and thus prevented the capital embedded in these assets to be used for other purposes. In other words, entrepreneurs could not sell their property and use the money to invest. They also could not borrow money from banks to expand or improve their businesses. De Soto's book, *The Other Path,* outlines his arguments.

De Soto found that another barrier to wealth in Peru and other less developed countries is government bureaucracy. It took de Soto and others six and a half years and 207 administrative steps in 52 government offices to obtain legal authorization to build a house on state-owned land. It took 289 six-hour days

LEARNING **goals**

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

1. Compare and contrast the economics of despair with the economics of growth.
2. Explain what capitalism is and how free markets work.
3. Discuss the major differences between socialism and communism.
4. Explain the trend toward mixed economies.
5. Discuss the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.
6. Define *fiscal policy* and *monetary policy*, and explain how each affects the economy.

CHAPTER 2

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and $1,231 in fees (that's about 31 times the monthly minimum wage in Peru) to legally open a garment workshop. In short, it is often very difficult and very expensive to become an entrepreneur in less developed countries. And entrepreneurship is the major source of wealth.

De Soto estimates that the value of real estate held, but not owned, by the poor in less developed countries is worth at least $9.3 trillion. That's a lot of money that could be used to start or expand businesses, hire more people, and create wealth. De Soto's second book, *The Mystery of Capital*, goes into more detail about how property ownership leads to the creation of wealth.

De Soto is now the president of the Institute for Liberty and Democracy, a Lima-based think tank. He says that two-thirds of humanity is not in a state to participate in a modern market economy, and that is his biggest challenge. De Soto finds this to be true around the world—from Peru to Egypt, Russia, Africa, and the Philippines. He found, for example, that it takes 25 years of red tape to legally gain the kind of home in Manila that people now get through squatting. He cites Switzerland and Japan as two countries that went from relative poverty to wealth by modifying their property laws. As you can imagine, de Soto has his share of people who don't agree with him. Articles have been written challenging his thinking, and his life has been threatened. But such challenges only help him bring the issue of poverty to the forefront and urge countries to change their laws to make prosperity a reality.

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 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 effect that economic systems have on the wealth and the happiness of communities throughout the world.

Sources: Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000); Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper & Row, 1989); Hernando de Soto's biography, www.Cato.org/special/friedman/desoto/ (accessed March 7, 2006; Jeremy Main, "How to Make Poor Countries Rich," *Fortune,* January 16, 1989; N. Stephan Kinsella, ed., book review, *Journal of Libertarian Studies,* Winter 2002; and www.nytimes.com/books/00/12/24/reviews/00124.24skidelt.html, 2002 (accessed in 2006).

HOW ECONOMIC CONDITIONS AFFECT BUSINESSES

Unlike Peru and other developing countries, the United States is a relatively wealthy country. Its entrepreneurs can get funding for risky projects like starting a business.[1] South America, on the other hand, is relatively poor, and there is less money available for entrepreneurial ventures. Why is that? Why is South Korea comparatively wealthy and North Korea suffering economically, with many of its people starving?[2] Why is China's annual income per person ($944) much less than Taiwan's ($13,010)? 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 America's business success is due to an economic and social climate that allows businesses to operate freely. People are free to start a business anywhere and are just as free to fail. The freedom to fail and start again motivates people to try until they succeed because the rewards are often so great. Any change in the U.S. economic or political system has a major influence on the success of the business system. *Global* economics and politics also have a major influence on businesses in the United States. Therefore, to understand business, you must also understand basic economics and politics.

Sam Walton, founder of Wal-Mart, is just one of millions of men and women who have created wealth for their families and their countries when given the chance. That chance comes when a free market (one not controlled by government) is introduced and people can find a little money to get started.[3]

The economic contrast is remarkable. Business is booming in Seoul, South Korea (pictured on 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. South Korea has 110 telephones per 100 residents while North Korea has just 5. The annual income per person in the North is 8 percent of that in the South. What do you think accounts for the dramatic differences in the economies of these two neighboring countries?

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. Remember from Chapter 1 that these resources (land, labor, capital, entrepreneurship, and knowledge) are called *factors of production*.

There are two major branches of economics: **macroeconomics** looks at the operation of a nation's economy as a whole and **microeconomics** looks at the behavior of people and organizations in particular markets. For example, while macroeconomics looks at how many jobs exist in the whole economy, microeconomics examines how many people will be hired in a particular industry or a particular region of the country. Topics discussed in this chapter that are part of macroeconomics include gross domestic product (GDP), the unemployment rate, and price indexes. Chapter topics that deal with microeconomic issues include pricing and supply and demand.

Some economists define economics as the allocation of "scarce" resources. They believe that resources are scarce and need to be carefully divided among people, usually by the government. 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 available to do that. **Resource development** is the study of how to increase resources and to create the conditions that will make better use of those resources (e.g., recycling and oil conservation).[4] Outside of government, businesses may contribute to an economic system by inventing products that greatly increase available resources. For example, businesses may discover new energy sources (e.g., hydrogen), new ways of growing food, and new ways of creating needed goods and services.[5] For example, people are starting to raise more fish in pens out in the ocean in a process known as *mariculture*.[6] Such processes could lead to more food for everyone and more employment.

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 that looks at the operation of a nation's economy as a whole.

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

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

Why Economics Was Known as the "Dismal Science"

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 there would soon be too many people and not enough food and other resources. Thomas Malthus made this argument in the late 1700s and early 1800s. In response to such views, Thomas Carlyle called economics the "dismal science." Followers of Malthus today (who are called neo-Malthusians) still believe that there are too many people in the world and that the solution to poverty is birth control, which includes such measures as forced abortions and forced sterilization. The latest statistics, however, show that the world population is growing more slowly than was expected, and in some industrial countries (e.g., Japan, Germany, Italy, Russia) growth may be so slow so that there will be too many old people and too few young people to care for them.[7] The problem with Social Security in the United States is largely due to too few young people to support retired people.

In the developing world, however, population will continue to climb relatively quickly. Some figures may help you understand these trends: In 1950, the 25 countries of North Africa and West Asia had a combined population less than half that of Europe—163 million compared to 350 million. By 2050, the combined population of North Africa and West Asia will be more than three times larger than that of Europe—1.3 billion to 401 million.[8] Such population increases may lead to greater poverty and more unrest. Studies about

No sentence in this whole text may be more important than the one that says, "Teach a person to start a fish farm, and he or she will be able to feed a village for a lifetime." That is a much more important concept than the traditional saying: "Teach a man to fish and you feed him for a lifetime." The answer to ending poverty in the world is to teach people how to form their own businesses so that they can provide food, clothing, and other needed goods and services to others. What skills are likely to be needed first?

the effects of population growth on the economy are part of *macroeconomics*.

Some macroeconomists believe that a large population can be a valuable resource, especially if the people are educated. They believe that one of the keys to economic growth throughout the world is to better educate people. You've probably heard or read 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.[9] One way to begin understanding this challenge is to consider the theories of Adam Smith.

Growth Economics and Adam Smith

Adam Smith was one of the first people to imagine a system for creating wealth and improving the lives of everyone. Rather than believing that fixed resources had to be divided among competing groups and individuals, Smith envisioned creating more resources so that everyone could become wealthier. The year was 1776. Adam Smith's book *An Inquiry into the Nature and Causes of the Wealth of Nations* often is called simply *The Wealth of Nations*.

Adam Smith believed that *freedom* was vital to the survival of any economy, especially the freedom to own land or property and the freedom to keep the profits from working the land or running a business. He believed that people will work hard if they have incentives for doing so—that is, if they know they will be rewarded.

He made the desire for improving one's condition in life the basis of his theory. According to Smith, as long as farmers, laborers, and businesspeople (entrepreneurs) could see economic reward for their efforts (i.e., receive enough money in the form of profits to support their families), they would work long hours and work hard. As a result of those efforts, the economy would prosper—with plenty of food and all kinds of products available to everyone. Smith's ideas were later challenged by Malthus and others who believed that economic conditions would only get worse, but it is Smith, not Malthus, who is considered by some to be the *father of modern economics*.

How Businesses Benefit the Community

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

Under Adam Smith's theory, 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 **invisible hand** turns self-directed gain into social and economic benefits for all.

Entrepreneurs like Bill Gates are often quite generous with their money. He and his wife have given billions of dollars to other countries. Other businesspeople are equally generous, but don't always receive the same amount of attention because the dollar amounts are much smaller. Nonetheless, the compassion is still there. Why do you suppose you don't read or hear more about the generosity of businesspeople in the news media?

How is it that people working in their own self-interest produce goods, services, and wealth for others? The only way farmers in a given area can become wealthy is to sell some of their crops to others. To become even wealthier, farmers would have to hire workers to produce more food. As a consequence, people in that area would have plenty of food available and some would have jobs on the farms. So the farmers' self-centered efforts to become wealthy lead to jobs for some and food for almost all. Stop and envision that process for a minute, because it is critical to your understanding of economic growth in the United States and other free countries. The same principles apply to other products as well—everything from clothing to houses to iPods.

Smith assumed that as people became wealthier, they would naturally reach out to help the less fortunate in the community.[10] That has not always happened. Today, however, many U.S. businesspeople are becoming more concerned about social issues and their obligation to return to society some of what they've earned. For example, Bill Gates (the cofounder of Microsoft) and his wife, Melinda, have set up the largest charitable foundation in history, worth some $29 billion.[11] The foundation has helped save at least 700,000 lives in poor countries through its investments in vaccinations.[12] The Bill and Melinda Gates Foundation works to improve schools; wire libraries to the Internet; and improve world health by providing vaccines, training people in health matters, and more.[13] Ninety percent of U.S. business owners contribute money to charities, compared with 70 percent of U.S. households. Businesses donated millions of dollars to help the victims of Hurricane Katrina, and many businesspeople were on the scene as volunteers. 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; therefore, there needs to be more emphasis on ethics at all stages in business education. You can explore your own ethical position regarding responses to people in need by looking at the Making Ethical Decisions box on page 34.

MAKING ethical decisions

Helping Disaster Victims

Hurricane Katrina, which struck the U.S. Gulf Coast in late August 2005, has been called "the greatest natural disaster in the history of the United States." Thousands of people in Louisiana, Mississippi, and Alabama lost their homes and were sent to other areas of the country with no money, no job, and no permanent place to live. Some were put up in motels. Others found refuge in football arenas or people's homes. Many of the people left without any identification, bank statements, or insurance papers. Chances are that some of the people who were made homeless and jobless will remain so for many months, if not years.

There has been a lot of attention given to the failures of various organizations after Hurricane Katrina. But there were and are many successes as well. The problem is simply too large for most organizations to handle. The Red Cross is just one of many organizations doing their best to help people get through the crisis.

Imagine you live in an area where the homes are medium priced. You have plenty of food to eat and spare rooms in the house. You know that the need is great and the ethical thing is for everyone to do his or her part. "We are all Americans," the news media are saying, and you understand what such a message means. You can send money to the Red Cross, the Salvation Army, or other charities; you can go down to the endangered areas and

try to help; or you can offer your home for protection and aid until things get better. What are the potential consequences of each action? What action are you most likely to take, if any? And why? What can ethical businesspeople do to help?

Sources: Anna Mulrine, "To the Rescue," *U.S. News and World Report*, September 12, 2005, pp. 20–26; "The Lost City," *Newsweek,* September 12, 2005, pp. 40–52; and various news reports on TV and radio, 2005–2006.

progress assessment

- What is the difference between macroeconomics and microeconomics?
- Why was economics known as the "dismal science"?
- What is better for an economy than teaching a person to fish?
- What does Adam Smith's term *invisible hand* mean? How does the invisible hand create wealth for a country?

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 had ever been created 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.

Great disparities in wealth remained or even increased. Many businesspeople owned large homes and fancy carriages, while most workers lived in

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

Frank and Ernest

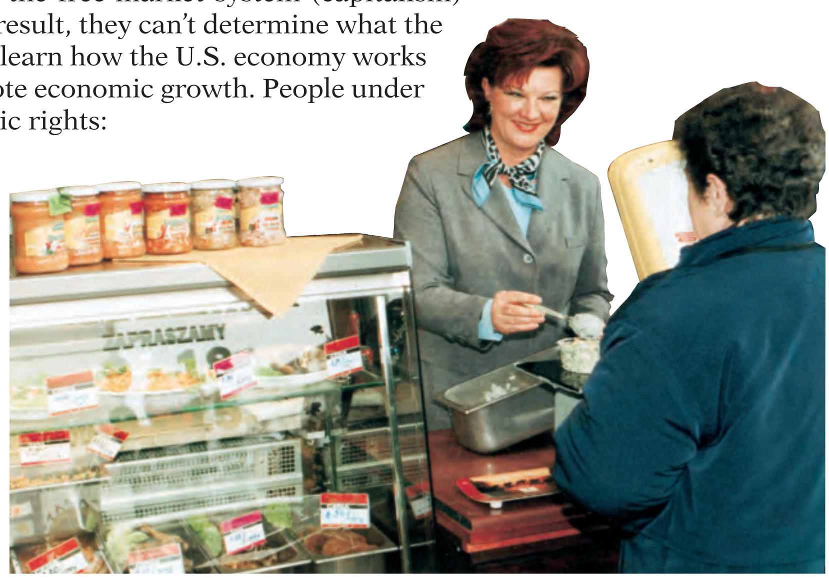
humble surroundings. Nonetheless, there was always the promise of better times. One way to be really wealthy was to start a successful business of your own.[14] Of course, it wasn't that easy—it never has been. Then and now, you have to accumulate some money to buy or start a business, and you have to work long hours to make it grow. But the opportunities are there.[15]

The economic system that has led to wealth creation in much of the world is known as capitalism. **Capitalism** is an economic system in which all or most of the factors of production and distribution (e.g., land, factories, railroads, and stores) are privately owned (not owned by the government) and are operated for profit. In capitalist countries, businesspeople decide what to produce; how much to pay workers; how much to charge for goods and services; whether to produce certain goods in their own countries, import those goods, or have them made in other countries; and so on. No country is purely capitalist, however. Often the government gets involved in issues such as determining minimum wages and setting farm prices, as it does in the United States. But the *foundation* of the U.S. economic system is capitalism. Similarly, capitalism is the foundation for the economies of England, Australia, Canada, and most other developed nations.

The people of Poland have learned that moving from a communist to a capitalist system is not easy. However, some entrepreneurs flourished. Wala Lukaszuk, for example, enjoyed early success with her own salad bar, but she is now experiencing competition from larger businesses. Capitalism does not guarantee success; it only affords the opportunity to try. Have you talked with someone familiar with socialism or communism to compare the advantages and disadvantages with capitalism?

The Foundations of Capitalism

Some people don't understand how the free-market system (capitalism) works or what rights it confers. As a result, they can't determine what the best economic system is. You should learn how the U.S. economy works and what mechanisms exist to promote economic growth. People under free-market capitalism have four basic rights:



1. *The right to private property.* This is the most fundamental of all rights under capitalism. It 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 as they do if they didn't own the land and

couldn't keep the profits from what they earned? It is the right to private property that Hernando de Soto is fighting for (see this chapter's Opening Profile).

2. *The right to own a business and to keep all of 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.
3. *The right to freedom of competition.* Within certain guidelines established by the government, individuals are free to compete with other individuals or businesses by offering new products and promotions. To survive and grow, businesses need laws and regulations, such as the laws of contracts, which ensure that people will do what they say they'll do.
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 freedoms of choice include where to live and what to buy or sell.

One benefit of such rights and freedoms is that people are willing to take more risks than they would otherwise. President Franklin D. Roosevelt believed that four additional freedoms were essential to economic success. They were the freedom of speech and expression, the freedom of every person to worship God in his or her own way, freedom from want, and freedom from fear. Do you see the benefits of these additional freedoms? Now that you understand these rights and freedoms, 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 to produce and in what quantities are made by the market—that is, by buyers and sellers negotiating prices for goods and services. You and I and other consumers in the United States and in other free-market countries 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. (Imagine, for example, what happened when the Chicago White Sox won the World Series in 2005.)[16] Manufacturers and retailers would increase the price of T-shirts, because they know people are willing to pay more than before. People in the clothing industry would also realize they could make more money by making more White Sox T-shirts. Thus, they would have incentive to pay workers to start work earlier and end later. Furthermore, the number of clothing companies making White Sox T-shirts would increase. How many T-shirts they make depends on how many we request or buy in the stores. The prices and quantities would continue to change as the amount of T-shirts we buy changed.

The same process occurs with most other products. The price tells producers how much to produce. As a consequence, there's rarely a long-term

People in Chicago are eager to buy White Sox T-shirts when the team is winning. That is especially true when they win the World Series. What happened to the price of White Sox T-shirts when the team won the World Series?

shortage of goods in the United States. 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.

How Prices Are Determined

How free markets work is an important part of economics. The main point is that, 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 White Sox T-shirt, but the quantity demanded at that 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
The quantity of products that manufacturers or owners are willing to sell at different prices at a specific time.

Supply refers to the quantity of products that 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 on page 38 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 T-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.

The Economic Concept of Demand

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

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, the relationship between price and quantity demanded can be shown in a graph. Figure 2.2 on page 38 shows a simple demand curve for T-shirts. The various points on the graph indicate the quantity demanded at various prices. For example, at a price of $45, the quantity demanded is just 5 shirts; but if the price were $5, the quantity demanded would increase to 35 shirts. The line connecting the dots is called a demand curve. It shows the relationship between quantity demanded and price.

The Equilibrium Point, or Market Price

It should be clear to you after reviewing Figures 2.1 and 2.2 that the key factor in determining the quantity supplied and the quantity demanded is *price.* Sellers prefer a high price, and buyers prefer a low price. If you were to lay one of the two graphs on top of the other, the supply curve and the demand curve would cross. At that crossing point, the quantity demanded and the quantity supplied would be 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).

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.

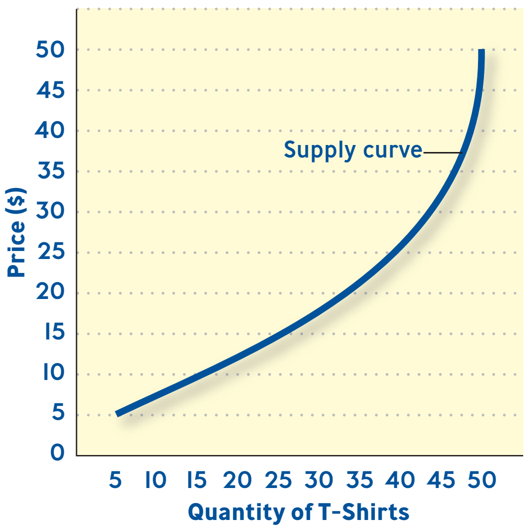


figure 2.2

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.

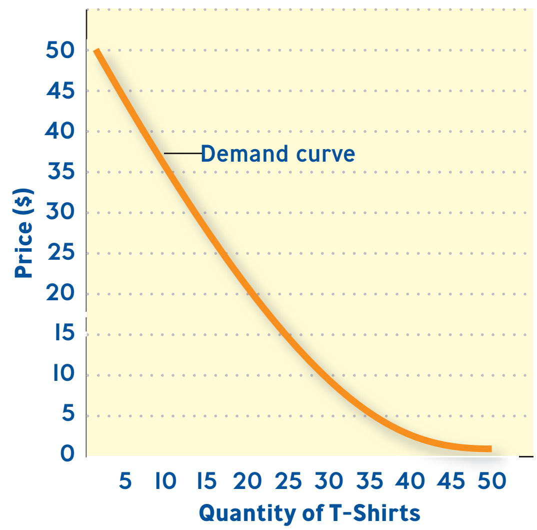
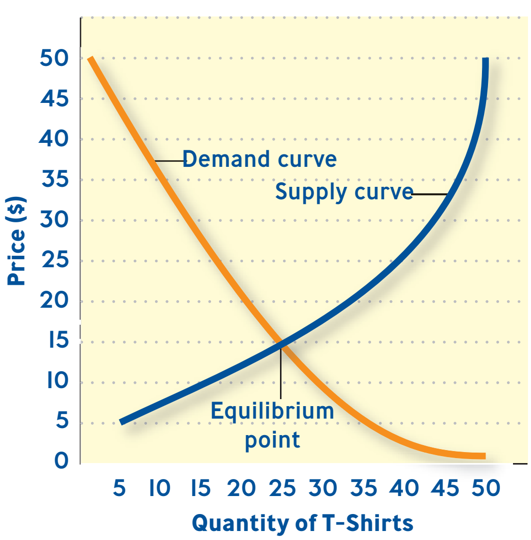


figure 2.3

THE EQUILIBRIUM POINT

The place where quantity demanded and 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.



That crossing point is known as the *equilibrium point* or the equilibrium price. In the long run, that price would become the market price. **Market price**, then, is determined by supply and demand.

Proponents of a free market would argue that, because supply and demand interactions determine prices, there is no need for government involvement or government planning. If surpluses develop (i.e., if quantity supplied exceeds quantity demanded), a signal is sent to sellers to lower the price. If shortages develop (i.e., if quantity supplied is less than quantity demanded), a signal is sent to sellers to increase the price. Eventually, supply will again equal demand if nothing interferes with market forces. You saw such price swings when the oil supply was cut in 2005 because of Hurricane Katrina. When supplies were low because of the hurricane, the price of gasoline went up (dramatically). When supplies were again plentiful, the price of gas fell, and went up again dramatically when overseas demand increased. The Dealing with Change box shows you what happens when changes occur faster than a company is able to adapt.

In countries without a free market, there is no such mechanism to reveal to businesses (via price) what to produce and in what amounts, so there are often shortages (not enough products) or surpluses (too many products). In such countries, the government decides what to produce and in what quantity, but the government 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 also develop.

DEALING WITH **change**

Adapting to Swings in Demand

Imagine that your local professional baseball team has not been winning many games in the last few years. I'm sure many of you can identify with that. Ticket prices are set, and the season begins. Because of a few new people on the team, the team begins winning game after game and the demand for tickets goes up. The owners cannot raise the prices without creating great tumult among the fans, so the price remains stable. But an informal market (among fans) grows for tickets, often on the Internet. Prices go up. Revenue also goes up for the owners because they sell a lot more hot dogs and beverages.

But what happens if the team starts losing again? Demand for tickets falls. The owners begin losing money at the concession stand. What can the owners do to adjust? You can see how adapting to changes in demand are often difficult to make.

The same is true with auto sales. When gas prices went up dramatically in 2005 and 2006, auto dealers found themselves with too many SUVs in their inventories. Also, there weren't enough hybrid cars (combination gas/electric vehicles with high gas mileage). Auto manufacturers simply could not respond quickly to the rapid changes in demand. What other examples could you cite that show the lag between changes in supply and/or demand and the reaction by businesspeople?

Sources: Larry Armstrong, "Are You Ready for a Hybrid?," *BusinessWeek*, April 25, 2005, pp. 118–26, and Victoria Murphy, "Seattle's Best-Kept Secret," *Forbes*, April 25, 2005, pp. 86–88.

Competition within Free Markets

market price
The price determined by supply and demand.

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

perfect competition
The market situation in which there are many sellers in a market and no seller is large enough to dictate the price of a product.

Perfect competition exists when there are many sellers in a market and no seller is large enough to dictate the price of a product. Under perfect competition, sellers produce products that appear to be identical. Agricultural products (e.g., apples, corn, potatoes) are often considered to be the closest examples of such products. You should know, however, that 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 is an example of perfect competition.

monopolistic competition
The market situation in which a large number of sellers produce products that are very similar but that are perceived by buyers as different.

Monopolistic competition exists when a large number of sellers produce products that are very similar but are perceived by buyers as different (e.g., hot dogs, candy, personal computers, T-shirts). Under monopolistic competition, 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 for just a moment. Through tactics such as advertising, branding, and packaging, sellers try to convince buyers that their products are different from those of competitors. Actually, the competing products may be similar or even interchangeable. The fast-food industry, in which there are often pricing battles between hamburger places, offers a good example of monopolistic competition.

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

An **oligopoly** is a form of competition in which just a few sellers dominate a market. Oligopolies exist in industries that produce products such as breakfast cereals, tobacco, automobiles, soft drinks, aluminum, and aircraft. One reason some industries remain in the hands of a few sellers is that the initial investment required to enter the business is tremendous.

In an oligopoly, prices for products from different companies tend to be close to the same. The reason for this is simple: Intense price competition would lower profits for all the competitors, since a price cut on the part of 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 a situation of oligopoly. Note, for example, that most cereals are priced about the same, as are soft drinks. Thus, advertising is a major factor in which of the few available brands consumers buy because often it is advertising that creates the perceived differences.

monopoly
A market in which there is only one seller for a product or service.

A **monopoly** occurs when there is only one seller for a product or service. That is, one seller controls the total supply of a product and the price. In the United States, laws prohibit the creation of monopolies. The U.S. legal system has permitted monopolies in the markets for public utilities that sell natural gas, water, and electric power. These utility companies' prices and profits usually have been monitored and controlled by public service commissions that are supposed 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. New legislation has ended the monopoly status of utilities in some areas, and consumers in those areas are able to choose among utility providers. The intention of this *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 quality products at fair prices with good service; otherwise, they will lose customers to those businesses that do provide good products, good prices, and good service.

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.[17] 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. Business owners and managers make more money and have more wealth than lower-level workers.[18] Similarly, people who are old, disabled, or sick may not be able to start and manage a business. Others may not have the talent or the drive to start and manage a business or farm. What should society do about such inequality? Not everyone in the United States is as generous as Bill Gates. In fact, the desire to produce as much as possible and to create as much wealth as possible has led some businesspeople (throughout history and even in some places still today) to use such practices as slavery and child labor.

One of the dangers of free markets is that businesspeople and others may let greed dictate how they act. Recent charges made against some big businesses—oil companies, accounting firms, telecommunications firms, insurance companies, drug companies, and others—indicate the scope of this danger. Some businesspeople have deceived the public about their products, and others have deceived their stockholders about the value of their stock.[19] All this was done in order to increase the executives' personal assets.

Clearly, some government laws, rules, and regulations are necessary to make sure that all of businesses' stakeholders are protected and that people who are unable to work get the basic care they need. To overcome the limitations of capitalism, some countries have adopted an economic system called socialism. It, too, has its good and bad points. We explore the advantages and disadvantages of socialism after the 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 some of the limitations of free markets?

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 evenly distributed among the people.

UNDERSTANDING SOCIALISM

Socialism is an economic system based on the premise that some, if not most, basic businesses—such as steel mills, coal mines, and utilities—should be owned by the government so that profits can be more evenly distributed among the people.[20] Entrepreneurs often own and run the smaller businesses, but private businesses and individuals are taxed relatively steeply to pay for social programs. The top federal personal income tax rate in the United States, for example, is 35 percent, but in some socialist countries the top rate is as much as 60 percent. While people in the United States pay state sales taxes of about 5 percent, more or less (more in California, less—in fact, nothing—in Delaware), socialist countries charge a value-added tax (which is something like a sales 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 that the government should be the agency that carries out the distribution.

Socialism has been a lot more successful in some countries than others. This photo shows Denmark's modern and clean public transportation system. On the other hand, France experienced street riots from young people who resisted legislation that would have allowed businesses to fire younger workers. That legislation was then withdrawn. What other factors may lead to slow growth in socialist countries?

The Benefits of Socialism

The major benefit of socialism is supposed to be social equality. There is supposed to be more equality of outcome in socialism than in capitalism because income is taken from the wealthier people, in the form of taxes, and redistributed to the poorer members of the population through various government programs. Free education (even through the college level), free health care, and free child care are some of the benefits socialist governments distribute to their people (using the money from taxes). Workers in socialist countries usually get longer vacations than workers in capitalist countries. They also tend to work fewer hours per week and have more employee benefits, such as generous sick leave.

The Negative Consequences of Socialism

Socialism may create more equality than capitalism, but it takes away some of businesspeople's incentives to start work early and leave work late. For example, tax rates in some nations once reached 85 percent. Today, doctors, lawyers, business owners, and others who earn a lot of money have 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: Say that after the first exam, those students 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. What would happen to the incentive of those who got an A on the first exam? Would they study as hard for the second exam, knowing that they would have to give away any points above 80? What about those who got 70s? Would they work less hard if they knew that they would get extra points if they didn't do well? 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 results 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. Over the past decade or so, most socialist countries have simply not kept up with the United States in new inventions, job creation, or wealth creation.[21] Communism may be considered as a version of socialism. We shall explore that system next.

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

UNDERSTANDING COMMUNISM

Communism is an economic and political system in which the state (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.

When you live in a relatively rich country with free markets, scarcity of goods or services is a rarity indeed. But that is not true worldwide. This photo, for example, shows what happens when there is a scarcity of water. People must scramble to find enough water to drink and bathe. What other goods and services are often unavailable in countries without free markets?

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 economic needs of the people are. As a result, shortages of many items may develop, including shortages of food and basic clothing. Another problem with communism is that it doesn't inspire businesspeople to work hard because the government takes most of their earnings. Therefore, although communists once held power in many nations around the world, communism is slowly disappearing as an economic form.

Most communist countries today are now suffering severe economic depression, and some people (for example, in North Korea) are starving. The people in Cuba are suffering from the lack of goods and services readily available in most other countries, and some people fear the government.[22] There seems to be a movement toward communist principles in Venezuela, following the Cuban model.[23] Other countries in the region may follow. Some parts of the former Soviet Union remain under communist concepts, but the movement there, until recently, has been toward free markets. In fact, Russia now has a flat tax of 13 percent, much lower than the tax rate in the United States. When Russia introduced that flat rate, tax revenues jumped by nearly 30 percent, in part because people no longer did whatever they could to avoid paying their taxes. The trend away from communism toward free markets is now appearing in Vietnam[24] and parts of China.[25] The regions in China that are most free have prospered greatly while the rest of the country has grown relatively slowly. The Spotlight on Small Business box has some interesting stories about entrepreneurship and growth in China.

SPOTLIGHT ON small business

China's Entrepreneurs Create Wealth

Economically, there are two Chinas. One China is the farming interior, where the people are very poor and the prospects for the future are rather dim. The other China consists of fast-growing urban areas, where incomes are much higher and the prospects for growth are very good. As a consequence, the share of China's population living in towns and cities has risen to 40 percent today from only 18 percent in 1978. The entrepreneurial stories of those who have left the farm are the stories of the future of China.

Yu Chengyu was a farmer who tried to support his family of five on a small farm. It is difficult to save money to move away from a farm in China because the government still owns the land and people cannot sell the land to get funds to start a business. Nonetheless, several years ago Yu moved to a city to sell homemade furniture. Now he has the biggest shop on his block, selling motor scooters, TV sets, and washing machines. He employs six other people in his business, creating more wealth for the community.

Han Dexun has a similar story to tell. He moved to Beijing from a village a decade ago to work for an uncle who had started a small furniture factory. Eventually he left to start his own business doing interior renovations. He has brought many relatives, friends, and neighbors into Beijing to find jobs, and he employs several of them on his own crews.

You don't have to look far to see the results of the rapid growth of Chinese businesses. There are "Made in China" stickers on clothes, furniture, and other products in stores throughout the United States. The more freedoms the people in China experience, the faster the overall economy is sure to grow. The same is true in India and other developing countries. One way you can help poor people in such countries to prosper and grow is to contribute to microlending firms like Grameen or the Foundation for International Community Assistance (FINCA). Such firms provide small loans to small businesses to get them started or to help them grow. More prosperity throughout the world could lead to less international tensions and greater peace.

Sources: Jason Dean, "Living the Chinese Dream," *The Wall Street Journal,* April 26, 2005, p. A12; Jeffrey Gangemi, "Microcredit Missionary," *BusinessWeek*, December 26, 2005, p. 20; and Dexter Roberts, "How Rising Wages Are Changing the Game in China," *BusinessWeek,* March 27, 2006, pp. 32–35.

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. Thus, to sum up the preceding discussion, the two major economic systems vying for dominance in the world today can be defined 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 used to describe this economic system.
2. **Command economies** exist when the government largely decides (commands) what goods and services will be produced, who will get them, and how the economy will grow. *Socialism* and *communism* are the popular terms used to describe variations of this economic system.

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.

The experience of the world has been that neither free-market nor command economies have resulted in optimum economic conditions. Free-market mechanisms haven't been responsive 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. Over time, voters in free-market countries, such as the United States, have therefore elected officials who have adopted many social and environmental programs such as Social Security, welfare, unemployment compensation, and various clean air and water acts.

REACHING BEYOND
our borders

Finding New Markets Overseas

Growth in many U.S. companies has slowed in recent years. This includes companies in the once fast-growing service sector. One solution to the problem is to explore markets in other countries. That is just what Citigroup is doing. Citigroup is one of the largest financial services companies in the world. It has about 120 million customers in more than 100 countries. Citibank is its banking arm. Despite its worldwide success, Citigroup is not standing still. It is reaching out to such fast-growing countries as Brazil, Mexico, Russia, India, and China—54 more countries in all.

It is not as easy as you might imagine to open banks in other countries. You have to work with government officials and regulators to allow you to create the legal mechanisms to open a bank, provide loans, and distribute credit cards. But that is only the beginning. You then have to convince people who have never used a bank or have lost money in banks to trust the bank to keep their money. You have to teach people how to use credit cards. You also have to adapt to the many rules and regulations that apply to banking or help the country to create new rules. That is what Citigroup had to do in Russia, where there was no system for deposit insurance, for example. Charging interest for credit card use was also new to the country.

Many other companies are going through similar struggles in their attempts to develop markets overseas. Each country has its own economic system, legal system, banking system, and regulations regarding the sale of goods and services. That is an opportunity for you. If you are willing to learn other languages; move to another country; learn that country's laws, customs, and culture; and adapt to its needs, you can become quite successful. Often the markets are wide open and the possibilities almost endless. Sound interesting?

Sources: Bernard Condon, Michael Freedman, and Naazneen Karmali, "Globetrotter," *Fortune,* April 18, 2005, pp. 66–86; www.citigroup.com (accessed March 7, 2006); and Kate Linebaugh, "How Foreign Banks Scaled the Chinese Wall," *The Wall Street Journal,* February 23, 2006, pp. C1 and C5.

Socialism and communism, for their part, haven't always created enough jobs or wealth to keep economies growing fast enough. As a consequence, communist governments are disappearing and socialist governments have been cutting back on social programs and lowering taxes on businesses and workers. The idea is to generate more business growth and thus generate more revenue.[26] The Reaching Beyond Our Borders box discusses the problems companies may face when expanding markets overseas.

The trend, then, has been for so-called capitalist countries (e.g., England) to move toward more socialism and for so-called socialist countries (e.g., France) to move toward more capitalism. We say "so-called" because no country in the world is purely capitalist or purely socialist. 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 caused by the Internet.[27] The net effect of capitalist systems moving toward socialism and socialist systems moving toward capitalism is the emergence throughout the world of mixed economies.

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

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 the dominant way of allocating resources is by free-market mechanisms, then the leaders of such countries still call their system capitalism. If the dominant way of allocating resources is by the government, then the leaders call their system socialism. Figure 2.4 compares the various economic systems.

Like most other nations of the world, the United States has a mixed economy. The degree of government involvement in the economy today is a matter of some debate, as it has been at various times in the past. The government has now become the largest employer in the United States, which means that the number of workers in the public sector is more than the number in the entire manufacturing sector.

	CAPITALISM	SOCIALISM	COMMUNISM	MIXED ECONOMY
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, change jobs, buy and sell homes, 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. No 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 oversupply 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 over-supply 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.

figure 2.4

COMPARISONS OF KEY ECONOMIC SYSTEMS

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?

UNDERSTANDING THE ECONOMIC SYSTEM OF THE UNITED STATES

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.

The following sections will introduce the terms and concepts you'll need to understand the issues facing government and business leaders today in the United States. As an informed citizen, you can then become a leader in helping to create a world economy that is best for all.

Key Economic Indicators

Three major indicators of economic conditions are (1) the gross domestic product (GDP), (2) the unemployment rate, and (3) the 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. It will greatly increase your understanding if you learn the terms now.

Gross Domestic Product **Gross domestic product (GDP)** is the total value of final goods and services produced in a country in a given year. Either a domestic company or a foreign-owned company may produce the goods and services included in the 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 would be included in the U.S. GDP. Likewise, revenue generated by the Ford car factory in Mexico would be included in Mexico's GDP, even though Ford is a U.S. company.

If GDP growth slows or declines, there are often many negative effects on businesses. A major influence on the growth of GDP is how productive the workforce is, that is, how much output workers create with a given amount of input. In 2004, world GDP was growing at its fastest rate in 30 years. It was expected to continue that pace into 2005.[28]

Almost every discussion about a nation's economy is based on GDP. The total U.S. GDP in the early 2000s was over $11 trillion. The level of U.S. economic activity is actually larger than the GDP figures show because the figures don't take into account illegal activities (e.g., sales of illegal drugs). The high GDP in the United States is what enables Americans to enjoy such a high standard of living.[29]

The overall unemployment rate in the United States is less than 5 percent. That doesn't mean, however, that certain areas of the country or certain cities are not experiencing much higher unemployment rates. Unemployment insurance only goes so far to relieve such unemployment. How high is the unemployment rate in your area?

The Unemployment Rate The **unemployment rate** refers to the number 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 the rate rose rapidly to over 6 percent as a result of the

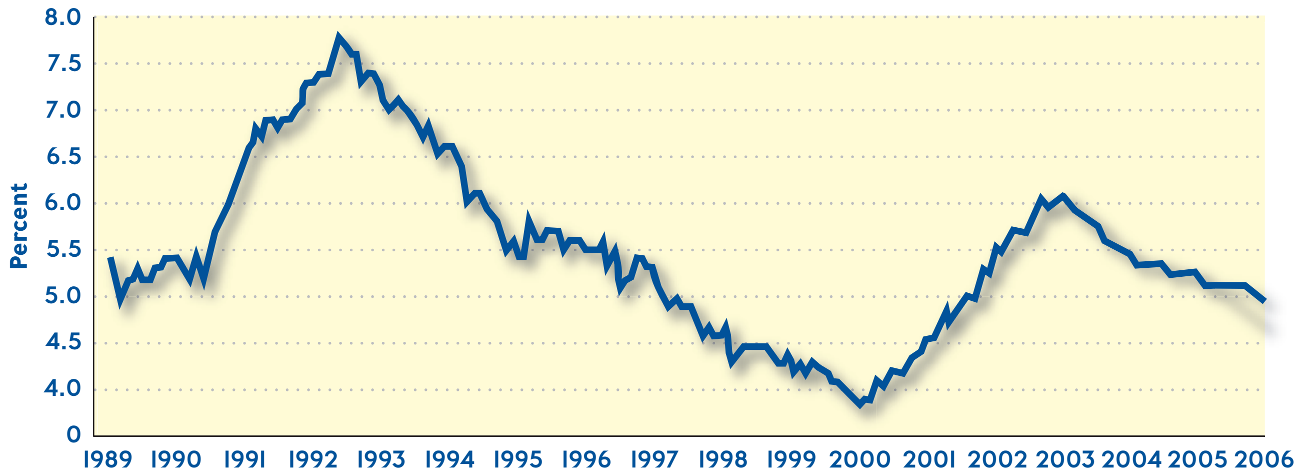


figure 2.5

U.S. UNEMPLOYMENT RATE, 1989–2006

economic slowdown of 2002–2003. It fell to less than 5 percent in 2006 (see Figure 2.5).[30] 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, industry shifts, and other cyclical factors. Nonetheless, for a variety of reasons, many of these individuals do not receive unemployment benefits.

The Price Indexes The price indexes help to measure the health of the economy by measuring the levels of inflation, disinflation, deflation, and stagflation. **Inflation** refers to a general rise in the prices of goods and services over time.[31] Rapid inflation is scary.[32] If the cost of goods and services goes up by just 7 percent a year, everything would double in cost in just 10 years or so. You can read more about such numbers in the Practicing Management Decisions Case at www.mhhe.com/ub8e.

Disinflation describes a situation in which 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 actually declining.[33] It occurs when countries produce so many goods that people cannot afford to

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.

There are several kinds of unemployment:

- *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

TYPES OF UNEMPLOYMENT

It's hard to imagine the damage caused by runaway inflation. In Germany, runaway inflation meant that you had to have a wheelbarrow full of money just to shop for groceries. These children are stacking up money for just such a shopping trip. One job of the Federal Reserve is to keep inflation in check. Can you see the effects of higher gasoline prices on other items in the store, or are the changes too small to notice?

buy them all (too few dollars are chasing too many goods). *Stagflation* occurs when the economy is slowing but prices are going up anyhow.[34]

The **consumer price index (CPI)** consists of monthly statistics that measure the pace of inflation or deflation. Costs of goods and services—including food, apparel, and medical care—are computed to see if 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. Recently the government created a new index called the chained consumer price index (C-CPI). The CPI failed to take into account the fact that consumers would shift their purchases as prices went up or down. For example, if the price of beef went up, consumers may switch to less-expensive chicken. The C-CPI takes such decisions into account; thus, the C-CPI is usually a lower figure than the CPI.[35]

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 the Internet.

Productivity in the United States

An increase in productivity means that a worker can produce more goods and services in the same period of time than before, usually through the use of machinery or other equipment. Productivity in the United States has gone up in recent years because computers and other technology have made the process of production faster and easier for many workers.[36] The higher productivity is, the lower costs are in producing goods and services, and the lower prices can be. Therefore, businesspeople are eager to increase productivity.

Starbucks is one firm that is very concerned about productivity. The faster an employee can make a venti-sized cold beverage, the more profits the store can make and the more productive the employee becomes. The more productive an employee becomes, the more he or she can be paid. Therefore, when someone discovered that it took two scoops of ice to make a venti-sized drink, a double-size scoop was invented that cut the production time by 14 seconds. A tall black drip coffee can be made in under 20 seconds, while a Venti Double Chocolate Chip Frappuccino Blended Crème takes closer to 90 seconds. Which drink would be more profitable for the store?[37]

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

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.

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 there are fewer new technologies available to assist service workers (e.g., teachers, clerks, lawyers, and personal service providers like barbers) than there are for factory workers.

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

Productivity in the Service Sector

In the service sector, other technological innovations are beginning to make workers more productive. The United States is ahead of much of the world in service productivity. However, 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* (productivity).

For example, you've probably noticed how many computers have been installed on college campuses. They add to the quality of education, but they don't necessarily boost professors' productivity. The same is true of some new equipment in hospitals, such as CAT scanners and PET scanners (more modern versions of the X-ray machine). They improve patient care but don't necessarily increase the number of patients that can be seen. In other words, today's productivity measures 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, measures 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.

The Business Cycle

Business cycles are the periodic rises and falls that occur in economies over time.[38] Economists look at a number of types of cycles, from seasonal cycles that occur within a year to cycles that occur every 48 to 60 years.

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

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. A **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 has many negative consequences for an economy: high unemployment, increased business failures, and an overall drop in living standards.
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 (1929–1933).
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.

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

depression
A severe recession.

One goal of economists is to predict ups and downs in the economy. That is very difficult to do. Business cycles are based on facts, but what those facts describe can be explained only by using theories.[39] Therefore, one cannot say with certainty what will happen next. One can only theorize. But one thing is for sure: The economy and the stock market *will* rise and fall.[40]

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

Business cycles show that over time the stock market is likely to rise *or* fall by significant amounts. Such cycles have shown to be rather consistent; that is, long periods of growth are typically followed by periods of decline. Investing, therefore, always involves a certain degree of risk, but usually the greater the risk the higher the payoff. Can you see why investors may be wise to study past trends before putting their money into stocks?

Stabilizing the Economy through Fiscal Policy

Fiscal policy refers to the federal government's efforts to keep the economy stable by increasing or decreasing taxes or government spending. The first half of fiscal policy involves 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 make and make the effort less rewarding. It follows, then, that (theoretically) low tax rates would tend to give the economy a boost.

In the United States, the percentage of GDP taken by the government through taxes at all levels (federal, state, and local) was about 20.7 percent in 1995. That rate had fallen to 18.4 percent by 2001, but it has been going up since then and is about 20.3 percent today.[41] When you count all fees, sales taxes, and more, taxes on the highest-earning citizens could exceed 50 percent. In your opinion, is that figure too high or not high enough? Why?

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

national debt
The sum of government deficits over time.

The second half of fiscal policy involves government spending. The government spends money on highways, social programs, education, defense, and so on. The *national deficit* is the amount of money that the federal government spends over and above the amount it gathers in taxes for a specific period (namely a fiscal year). Over time, such deficits increase the national debt. The **national debt** is the sum of government deficits over time. Recently, the national debt was over 8 trillion (see Figure 2.8). That's over $28,000 for every man, woman, and child in the United States, or over $112,000 for a family of four. (You can see what your current share of the national debt is by checking out the National Debt Clock at www.brillig.com/debt_clock.) At times, there is a *national surplus,* where tax revenues exceed expenditures, but that is a relatively rare event.

One way to lessen the annual deficits is to cut government spending. Many presidents have promised to make the government "smaller," that is, to lower government spending—but that doesn't happen very often. There seems to be a need for more social programs or more defense spending each year, and thus the deficits continue and add to the national debt. Some people believe that spending by the government helps the economy to 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?

Using Monetary Policy to Keep the Economy Growing

Have you ever wondered what organization adds 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 who are appointed by the president of the United

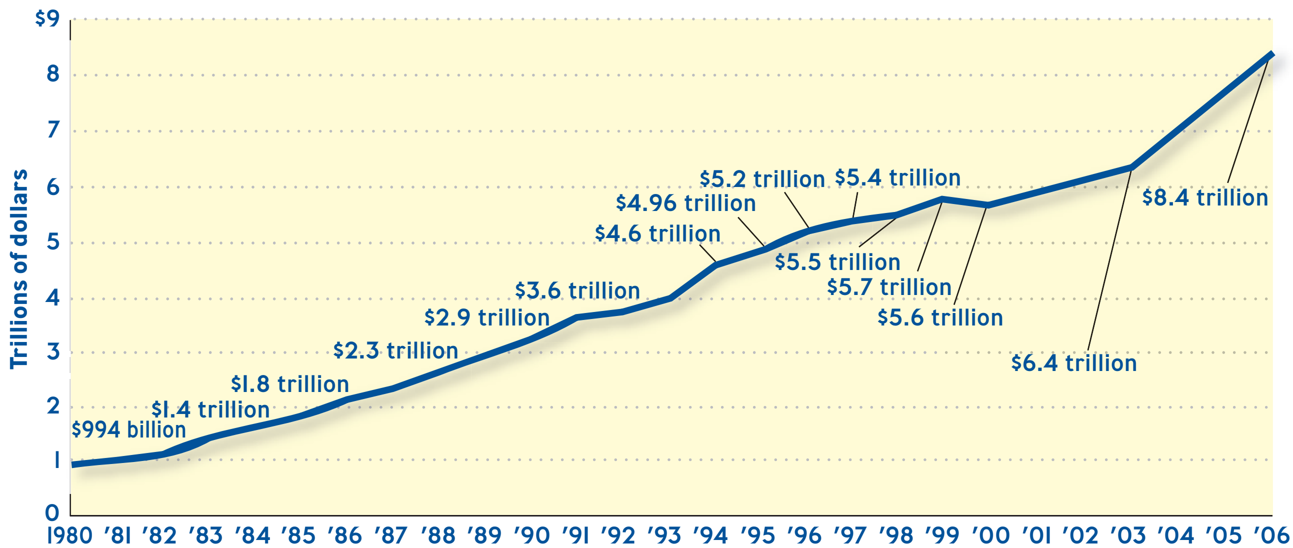


figure 2.8

THE NATIONAL DEBT

Source: Government data.

States. We will discuss the Fed in detail later in the book when we look at the subject of banking in Chapter 20. Our goal in this chapter is to simply introduce you to the concept of monetary policy and the role of the Fed in controlling the economy.

Monetary policy is the management of the money supply and interest rates. That policy is controlled by the Federal Reserve System. The most obvious role of the Federal Reserve 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 takes off. Raising and lowering interest rates should therefore help control the rapid ups and downs of the economy.

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

The Federal Reserve also controls the money supply. A simple explanation is that the more money that the Fed makes available to businesspeople and others, the faster the economy grows. To slow the economy, the Fed lowers the money supply. If you are eager to learn more about the Fed and the money supply, you can turn to Chapter 20 now. You don't need to know all the details, however, to understand that there are two major efforts being made to control the economy of the United States: fiscal policy (taxes and spending) and monetary policy (control over interest rates and the money supply).[42] The economic goal is to keep the economy growing so that more people can rise up the economic ladder and enjoy a satisfying quality of life.[43]

progress assessment

- Name the three economic indicators and describe how well the United States is doing according to 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

1. Compare and contrast the economics of despair with the economics of growth.

1. Economics is the study of how society chooses to employ resources to produce various goods and services and to distribute them for consumption among various competing groups and individuals.
   - **Why was economics known as the "dismal science"?**
   In the late 1700s and early 1800s, Thomas Malthus theorized that the human population would grow so fast that resources could not keep up. On the basis of his theories, some countries today have placed severe restrictions on population, including forced sterilization and forced abortions. The economic outlook for the long run was and is considered dismal in some countries.
   - **How does the government create a climate for economic growth?**
   In 1776, Adam Smith called the mechanism for creating wealth and jobs an invisible hand. Under his system (capitalism), businesspeople don't deliberately set out to help others. In fact, 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.

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

2. Capitalism is an economic system in which all or most of the means of production and distribution (e.g., land, factories, railroads, and stores) 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; how much to charge for goods and services; whether to produce certain goods in their own countries, import those goods, or have them made in other countries; and so on.
   - **What are the basic rights people have under capitalism?**
   The four basic rights under capitalism are (1) the right to 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 freedom of speech and expression, the freedom of every person to worship God in his or her own way, freedom from want, and freedom from fear.
   - **How does the free market work?**
   The free market is one in which decisions about what to produce and in what quantities are made by the market—that is, by buyers and sellers negotiating prices for goods and services. 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, then, is the mechanism that allows free markets to work.

3. Discuss the major differences between socialism and communism.

3. 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 creates more social equity. Compared to workers in capitalist countries, workers in socialist countries not only receive more free education and health care benefits but also work fewer hours, have longer vacations, and receive more free benefits in general, such as child care. The major disadvantage of socialism is that it lowers the profits of owners and

managers, thus cutting 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. While there are many countries practicing socialism, there are only a small number (e.g., North Korea, Cuba, Vietnam) still practicing communism.

4. Explain the trend toward mixed economies.

4. A mixed economy is one that is part capitalist and part socialist. That is, 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 countries of the world.

- **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 offers.

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

5. Three major indicators of economic conditions are (1) the gross domestic product (GDP), (2) the unemployment rate, and (3) the price indexes.

- **What are the key terms used to describe the U.S. economic system?**

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 number of civilians at least 16 years old who are unemployed and who 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 consumers buy. It contains monthly statistics that measure the pace of inflation (consumer prices going up) or deflation (consumer prices going down). Recently, the government created a new index called the chained consumer price index (C-CPI) because the CPI failed to take into account the fact that consumers would shift their purchases as prices went up or down. Productivity is the total volume of goods and services one worker can produce in a given period. Productivity in the United States has increased due to the use of machinery and other technology.

- **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.

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

6. Fiscal policy consists of government efforts to keep the economy stable by increasing or decreasing taxes or government spending. The search is for a good balance between taxes and spending so that the economy can grow and the government can fund its various programs.

- **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 provides a boost to the economy as businesses borrow and spend more money and hire more people.

key terms

brain drain 41
business cycles 49
capitalism 34
command economies 43
communism 42
consumer price index (CPI) 48
deflation 47
demand 37
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supply 37
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critical thinking questions

1. Recently, the U.S. Supreme Court ruled that cities could have voucher programs that give money directly to parents, and the parents can then choose between competing schools: public and private. The idea for promoting such a ruling was to create competition among schools. As with businesses, schools were expected to improve their products (how effectively they teach) to win students from competitors. Supposedly, that would mean an improvement in all schools, private and public, and would benefit many students.

   a. Do you believe that such economic principles apply in both private and public organizations? Be prepared to defend your answer.
   b. Are there other public functions that might benefit from more competition, including competition from private firms?

2. 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, which often precludes them from searching for work. Furthermore, they believe that businesses create all the wealth that nonprofit groups distribute.

   a. Can you find some middle ground in this debate that would 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. 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 employment market today. Explain, for example, the high salaries that computer scientists are getting at Microsoft. Also explain why some people with graduate degrees aren't getting better pay than computer scientists who only have undergraduate degrees. Why do some librarians make less than some garbage collectors, even though the librarians may have a better education?
3. This exercise is intended to 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 war in Iraq; the creation of the Department of Homeland Security; the growth of the Internet; and the numerous charges against big businesses behaving illegally, unethically, and immorally. Have a group member prepare a short summary for the class.

taking it to the net * 1

Purpose

To compare the value of the dollar based on variances in the consumer price index.

Exercise

Do your parents ever tire of telling you how much things cost back in their day? Sure, things were cheaper then, but the value of a dollar was different too. Think about something you bought today (shoes, soda, candy bar, haircut—whatever). How much did the good or service you bought today cost your parents when they were your age? Find out by using the handy tool on the Federal Reserve Bank of Minneapolis's Woodrow Web site (http://woodrow.mpls.frb.fed.us/research/data/us/calc). The calculator uses the consumer price index to compare the value of the dollar in different years. Enter the cost of the item you bought today, the year you would like to compare it with, and—presto—you'll find out how Mom and Pop could get along on such a small paycheck. (For an even bigger shock, compare the current dollar to the dollar in your grandparents' day!)

1. How much would a $50 pair of jeans bought today have cost the year you were born?
2. How much would a job paying $6 an hour today have paid in 1970?
3. How much would a new car costing $18,000 today have cost the year your mother first got her driver's license?

taking it to the net * 2

Purpose

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

Exercise

Imagine your boss asked you to help her in preparing the company's sales forecast for the next 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 Web site (www.bea.doc.gov) and locate the gross domestic product data. Compute an annual figure for the last four years by averaging the quarterly data. Plot this on graph paper or a spreadsheet. Leave enough space for six years so that you can draw a projection line for the next two years.
2. On the Bureau of Labor Statistics' Web site (www.bls.gov), under Industries, click on Industries at a Glance to find information about the manufacturing industry. What is the employment trend in manufacturing over the last four years?
3. Return to the Bureau of Labor Statistics' home page and use the Search feature to find the manufacturing employment for the state of Illinois. Using the data from July, plot the trend in manufacturing employment in Illinois over the last four years.
4. If sales in your company tend to increase as the GDP increases and as employment in manufacturing in the United States and Illinois remains stable or increases, what do you think is going to happen to your company's sales?

casing the web

To access the case "The Rule of 72," visit **www.mhhe.com/ub8e** video case

Katrina's Aftermath

Free market capitalism has been credited with the marvelous growth and prosperity enjoyed by the United States and other developed countries. But no country really has a totally free market system. Always, the government acts to help assure those who are poor, elderly, or disabled that they will receive some minimum amount of assistance. Usually that assistance includes education or some kind of welfare assistance (e.g., food, housing, or tax relief). The resulting system is called a mixed economic system because it is a mixture of free market capitalism and government social programs. If the government programs are extensive, the system might be called socialism.

In the United States, there are many very rich people and many very poor people. Despite numerous efforts by businesses, government agencies, and nonprofit organizations to end poverty, poverty still persists. That point was illustrated vividly when hurricane Katrina hit the Gulf Coast region of the United States, and was especially apparent in New Orleans, Louisiana.

Who is to blame for persistent poverty? And why did the people in New Orleans suffer for so many days before assistance arrived? Is the government indifferent to the needs of some? Is the city government responsible, or the state government, or the federal government? There have been major natural disasters throughout the world in recent years, and the results have been much the same. Many people die; others lose their homes and jobs. Almost always, citizens try to help, but the task is simply too great. At times, even the state and federal government are overwhelmed by the need.

In the case of New Orleans, businesses like Wal-Mart responded rather quickly, but they couldn't get food and materials to people without help. Nonprofit groups of all kinds drove down to help, but government bureaucracy made it difficult, if not impossible, to get a coordinated effort going. Communications between and among various government, private, and nonprofit organizations was almost nonexistent. Much of the infrastructure (roads, rivers, water system, electricity, and so forth) were not operating.

In short, capitalism is a great system for creating wealth in a macroeconomic environment where supply and demand dictate through prices what gets produced and in what quantity and quality. In the short run, however, shortages can exist for a while without the appropriate response. In the long run, the free market system will do its work. The demand for supplies will result in flows of goods. Homes will be rebuilt. Businesses will reopen. Jobs will be created. People will get on with their lives. That has happened again and again in Florida and other places where disaster has struck.

Wars and natural disasters create a real challenge for any economic system. The fastest response usually comes when people are free to create their own businesses, free to own their own land, free to set their own prices, and free to keep the profits from what they earn. Acadian Ambulance is an example of what free markets can do. In the midst of the Katrina disaster, the company had a satellite communication system up and running. Acadian was thus able to coordinate hospitals, law enforcement, and rescue workers. Land lines, cell phones, and Internet communications had all failed. But one creative company was able to rise above the chaos.

Ultimately, you and I, as taxpayers, will have to pay for the damages in the Gulf region. The government uses fiscal policy, taxes and spending, to keep the economy growing and to respond to people in need. The government also uses monetary policy to keep the economy growing at the right pace. That means that the Federal Reserve will raise or lower interest rates and control the money supply so that businesses can prosper and grow—creating jobs and minimizing poverty.

There have always been ups and downs in the economy. Though thick and thin, people have always responded by helping their neighbors and helping those throughout the world who have less. More and more countries are adopting the concepts of free markets and free trade. The results are obvious in places like China, India, South Korea, and around the world. A good understanding of economics is the basis for all such growth—and the reason for discussing economics early in this text.

Thinking It Over

1. No economic system has been able to respond quickly to the devastation caused by

war or major natural disasters. Why is the free market system more likely to respond faster? What advantages might a socialist system have in responding to the needs of the poor?

2. What could the government do to better coordinate the efforts of churches, other nonprofit organizations, government agencies, businesses, and individual citizens when emergencies strike? What factors have hindered such coordination in the past?

3. When disasters hit an area, the cost of everything seems to go up immediately: food, water, housing, gas, and so forth. Explain why this phenomenon may be a good thing, using the laws of supply and demand to explain your answer. What would happen if prices did not go up?