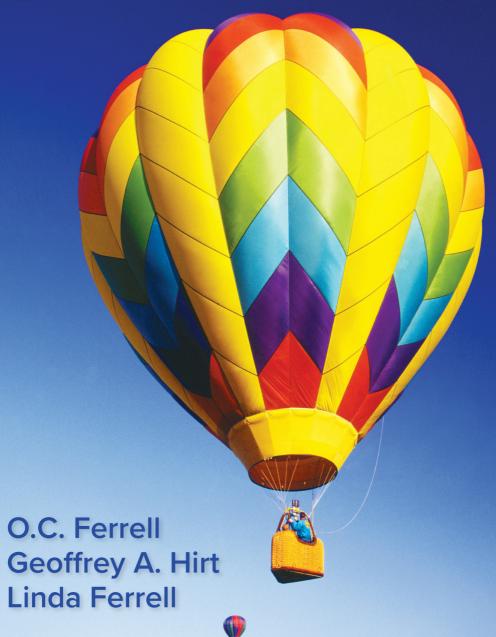
TWELFTH EDITION

Business Foundations

> A CHANGING WORLD







A Changing World

twelfth edition

O.C. Ferrell

Auburn University

Geoffrey A. Hirt

DePaul University

Linda Ferrell

Auburn University





BUSINESS FOUNDATIONS: A CHANGING WORLD, TWELFTH EDITION

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Authors

O.C. FERRELL



O.C. Ferrell is the James T. Pursell Sr. Eminent Scholar in Ethics and Director of the Center for Ethical Organizational Cultures in the Raymond J. Harbert College of Business,

Auburn University. He was formerly Distinguished Professor of Leadership and Business Ethics at Belmont University and University Distinguished Professor at the University of New Mexico. He has also been on the faculties of the University of Wyoming, Colorado State University, University of Memphis, Texas A&M University, Illinois State University, and Southern Illinois University. He received his PhD in marketing from Louisiana State University.

Dr. Ferrell is president of the Academy of Marketing Science. He is past president of the Academic Council of the American Marketing Association and chaired the American Marketing Association Ethics Committee. Under his leadership, the committee developed the AMA Code of Ethics and the AMA Code of Ethics for Marketing on the Internet. In addition, he is a former member of the Academy of Marketing Science Board of Governors and is a Society of Marketing Advances and Southwestern Marketing Association Fellow and an Academy of Marketing Science Distinguished Fellow. He has served for nine years as the vice president of publications for the Academy of Marketing Science. In 2010, he received a Lifetime Achievement Award from the Macromarketing Society and a special award for service to doctoral students from the

Southeast Doctoral Consortium. He received the Harold Berkman Lifetime Service Award from the Academy of Marketing Science and, more recently, the Cutco Vector Distinguished Marketing Educator Award from the Academy of Marketing Science.

Dr. Ferrell has been involved in entrepreneurial engagements, co-founding Print Avenue in 1981, providing a solution-based printing company. He has been a consultant and served as an expert witness in legal cases related to marketing and business ethics litigation. He has conducted training for a number of global firms, including General Motors. His involvement with direct selling companies includes serving on the Academic Advisory Committee and as a fellow for the Direct Selling Education Foundation.

Dr. Ferrell is the co-author of 20 books and more than 100 published articles and papers. His articles have been published in the Journal of Marketing Research, Journal of Marketing, Journal of Business Ethics, Journal of Business Research, Journal of the Academy of Marketing Science, AMS Review, and the Journal of Public Policy & Marketing, as well as other journals.

GEOFFREY A. HIRT



Geoffrey A. Hirt of DePaul University previously taught at Texas Christian University and Illinois State University, where he was chairman of the Department of Finance

and Law. At DePaul, he was chairman of the Finance Department from 1987 to 1997 and

held the title of Mesirow Financial Fellow. He developed the MBA program in Hong Kong and served as director of international initiatives for the College of Business, supervising overseas programs in Hong Kong, Prague, and Bahrain, and was awarded the Spirit of St. Vincent DePaul award for his contributions to the university. Dr. Hirt directed the Chartered Financial Analysts (CFA) study program for the Investment Analysts Society of Chicago from 1987 to 2003. He has been a visiting professor at the University of Urbino in Italy, where he still maintains a relationship with the economics department. He received his PhD in finance from the University of Illinois at Champaign-Urbana, his MBA at Miami University of Ohio, and his BA from Ohio Wesleyan University.

Dr. Hirt is currently on the Dean's Advisory Board and Executive Committee of DePaul's School of Music. The Tyree Foundation funds innovative education programs in Chicago, and Dr. Hirt also serves on the Grant Committee. Dr. Hirt is past president and a current member of the Midwest Finance Association, a former editor of the Journal of Financial Education, and also a member of the Financial Management Association. He belongs to the Pacific Pension Institute, an organization of public pension funds, private equity firms, and international organizations such as the Asian Development Bank, the IMF, and the European Bank for Reconstruction and Development.

Dr. Hirt is widely known for his textbook Foundations of Financial Management, published by McGraw-Hill/Irwin. This book, in its sixteenth edition, has been used in more than 31 countries and translated into more than 14 different languages. Additionally, Dr. Hirt is well known for his textbook Fundamentals of Investment Management, also published by McGraw-Hill/Irwin and now in its tenth edition. Dr. Hirt enjoys golf, swimming, music, and traveling with his wife, who is a pianist and opera coach.

LINDA FERRELL



Linda Ferrell is Professor and Chair of the Marketing Department in the Raymond J. Harbert College of Business, Auburn University. She was formerly Distinguished Professor

of Leadership and Business Ethics at Belmont University. She completed her PhD in business administration, with a concentration in management, at the University of Memphis. She has taught at the University of Tampa, Colorado State University, University of Northern Colorado, University of Memphis, University of Wyoming, and the University of New Mexico. She has also team-taught classes at Thammasat University in Bangkok, Thailand.

Her work experience as an account executive for McDonald's and Pizza Hut's advertising agencies supports her teaching of advertising, marketing management, marketing ethics, and marketing principles. She has published in the Journal of Public Policy & Marketing, Journal of Business Research, Journal of the Academy of Marketing Science, Journal of Business Ethics, AMS Review, Journal of Academic Ethics, Journal of Marketing Education, Marketing Education Review, Journal of Teaching Business Ethics, Marketing Management Journal, and Case Research Journal, and she is co-author of Business Ethics: Ethical Decision Making and Cases (eleventh edition), Management (third edition), and Business and Society (sixth edition).

Dr. Ferrell is the immediate past president of the Academy of Marketing Science and a past president for the Marketing Management Association. She is a member of the NASBA Center for the Public Trust Board, on the Mannatech Board of Directors, and on the college advisory board for Cutco/Vector. She is also on the Board, Executive Committee, and Academic Advisory Committee of the Direct Selling Education Foundation. She has served as an expert witness in cases related to advertising, business ethics, and consumer protection.





Welcome

The twelfth edition represents a complete and comprehensive revision. This is because so many events and changes in the environment relate to the foundational concepts in business. This means that an introduction to business product has to provide adequate coverage of dynamic changes in the economy as they relate to business decisions. We have listened to your feedback and incorporated needed changes in content, boxes, cases, exercises, support, online resources, and other features.

This is our fifth edition with a chapter on digital marketing and social networking in business. Since launching this chapter in the eighth edition, this dynamic area continues to change the face of business. Entrepreneurs and small businesses have to be able to increase sales and reduce costs by using social networking to communicate and develop relationships with customers. The sharing, or "gig," economy is transforming entrepreneurial opportunities for employees. For example, the number of independent contractors in our economy has increased to almost one-third of the workforce. The Internet is providing opportunities for peer-to-peer relationships for companies such as Uber, Lyft, TaskRabbit, as well as health care services like Dose. Digital marketing has helped many entrepreneurs launch successful businesses. The increase in independent contractors has contributed to a new trend called co-working. For example, WeWork, discussed in Chapter 10, is capitalizing on these co-working opportunities by offering flexible, agile workspaces to businesses ranging from freelancers to *Fortune* 500 companies.

Throughout the product, we recognize the importance of sustainability and "green" business. By using the philosophy *reduce*, *reuse*, *and recycle*, we believe every business can be more profitable and contribute to a better world through green initiatives. There is a "Going Green" box in each chapter that covers these environmental changes. Our "Entrepreneurship in Action" boxes also discuss many innovations and opportunities to use sustainability for business success. Sustainability is not only a goal of many businesses, but it is also providing career opportunities for many of our students.

We have been careful to continue our coverage of global business, ethics and social responsibility, and information technology as they relate to the foundations important in an introduction to business course. Our co-author team has a diversity of expertise in these important areas. O.C. Ferrell and Linda Ferrell have been recognized as leaders in business ethics education, and their insights are reflected in every chapter and in the "Business Integrity" boxes. Geoff Hirt has a strong background in global business development, especially world financial markets and trade relationships.

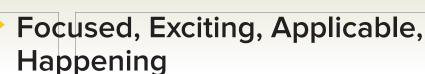
The foundational areas of introduction to business, entrepreneurship, small business management, marketing, accounting, and finance have been completely revised. Examples have been provided to which students can easily relate. An understanding of core functional areas of business is presented so students get a holistic view of the world of business. Box examples related to "Responding to Business Challenges,"

"Entrepreneurship in Action," "Going Green," and "Business Integrity" help provide real-world examples in these areas.

Our goal is to make sure that the content and teaching package for this book are of the highest quality possible. We wish to seize this opportunity to gain your trust, and we appreciate any feedback to help us continually improve these materials. We hope that the real beneficiary of all of our work will be well-informed students who appreciate the role of business in society and take advantage of the opportunity to play a significant role in improving our world. In this new edition, we have additional content to help our students understand how our free enterprise system operates and how we fit into the global competitive environment. This course is an opportunity for students to understand how they can create their own success and improve their quality of life.

O.C. Ferrell
Geoffrey A. Hirt
Linda Ferrell





Business Foundations: A Changing World, twelfth edition, offers faculty and students a focused resource that is exciting, applicable, and happening! What sets this learning program apart from the competition? An unrivaled mixture of exciting content and resources blended with application focused text and activities, and fresh topics and examples that show students what is happening in the world of business today!

Our product contains all of the essentials that most students should learn in a semester. *Business Foundations* has, since its inception, delivered a focused presentation of the essential material needed to teach introduction to business. An unrivaled mixture of exciting content and resources, application-focused content and activities, and fresh topics and examples that show students what is happening in the world of business today set this text apart!

Focused!

It's easy for students taking their first steps into business to become overwhelmed. Longer products try to solve this problem by chopping out examples or topics to make ad hoc shorter editions. *Business Foundations* carefully builds just the right mix of coverage and applications to give your students a firm grounding in business principles. Where other products have you sprinting through the semester to get everything in, Ferrell/Hirt/Ferrell allows you the breathing space to explore topics and incorporate other activities that are important to you and your students. The exceptional resources and the *Active Classroom Resource Manual* support you in this effort every step of the way.

Exciting

It's exciting to see students succeed! It's exciting to see more As and Bs in a course without grade inflation. Ferrell/Hirt/Ferrell makes these results possible for your course with its integrated learning package that is proven effective, tailored to each individual student, and easy to use.

Applicable

When students see how content applies to them, their life, their career, and the world around them, they are more engaged in the course. *Business Foundations* helps students maximize their learning efforts by setting clear objectives; delivering interesting cases and examples; focusing on core issues; and providing engaging activities to apply concepts, build skills, and solve problems.

Happening!

Because it isn't tied to the revision cycle of a larger book, *Business Foundations* inherits no outdated or irrelevant examples or coverage. Everything in the twelfth edition reflects the very latest developments in the business world—from the recent recession, high unemployment rates, and the financial instability in Europe to the growth of digital marketing and social networking. In addition, ethics continues to be a key issue, and Ferrell/Hirt/Ferrell use "Business Integrity" boxes to instill in students the importance of ethical conduct in business. To ensure you always know what's happening, join the author-led Facebook group page supporting this text.





New to This Edition

As always, when revising this material for the current edition, all examples, figures, and statistics have been updated to incorporate any recent developments that affect the world of business. Additionally, content was updated to ensure the most pertinent topical coverage is provided. We now provide bonus chapters in the text—Bonus Chapter A, The Legal and Regulatory Environment, and Bonus Chapter B, Personal and Financial Planning—to meet market demands. In addition, we have added a new online Appendix C, which provides the basics of risk management. Both insurable and noninsurable risk are covered in this appendix.

Here are the highlights for each chapter:

Chapter I: The Dynamics of Business and Economics

- New boxed features describing real-world business issues
- Updated unemployment statistics
- New chart on online retailing

Chapter 2: Business Ethics and Social Responsibility

- New boxed features describing issues in business ethics and social responsibility
- New data on global trust in different industries
- New examples about ethical issues in the sharing economy
- New content about aggressive financial or business objectives
- New example of a bribery scandal

Chapter 3: Business in a Borderless World

- New boxed features describing issues in international business
- Updated list of top 10 countries with which the U.S. has trade deficits/surpluses
- New content on U.S. aluminum and steel tariffs
- Updated Euro Zone details
- New details on the EU's General Data Protection Regulation (GDPR)

Chapter 4: Options for Organizing Business

- New boxed features describing real-world business issues
- New chart of world's biggest dividend payers
- Updated table of America's largest private companies

Chapter 5: \$mall Business, Entrepreneurship, and Franchising

- New boxed features describing current business issues
- Examples of innovative small businesses
- New information on artificial intelligence
- Updated table of the fastest growing franchises
- Updated table of the most business-friendly states

Chapter 6: The Nature of Management

- New boxed features describing current business issues
- New content about business models



- New table of compensation packages of CEOs
- · New content on gender equality
- New See for Yourself Videocase—JCF Fitness

Chapter 7: Organization, Teamwork, and Communication

- New boxed features describing current business issues
- New examples of organizational culture
- New content on artificial intelligence
- New stats on email usage in the workplace
- New See for Yourself Videocase—Freshii

Chapter 8: Managing Operations and Supply Chains

- New boxed features describing current business operational issues
- New content on marketing research and artificial intelligence
- New section on blockchain technology
- · New content on drone technology
- Extensive overhaul of Managing the Supply Chain section

Chapter 9: Motivating the Workforce

- New boxed features describing current business issues
- · New examples of organizational culture

Chapter 10: Managing Human Resources

- New boxed features describing current HR issues
- Updated common job interview questions
- New content on wage gap
- New example of how soft benefits inspire loyalty

Chapter II: Customer-Driven Marketing

- New boxed features describing current marketing issues
- New content on marketing orientation
- New content on supply chain management
- New content on marketing analytics dashboards

Chapter 12: Dimensions of Marketing Strategy

- New boxed features describing current marketing issues
- Logistics added as key term
- New definition for physical distribution key term
- New See for Yourself Videocase—Zappos

Chapter 13: Digital Marketing and Social Media

- New boxed features describing current digital marketing issues
- New stats on social media use by platform
- New stats on mobile app activities

Chapter 14: Accounting and Financial Statements

- New boxed features describing current accounting issues
- Updated rankings of accounting firms in the U.S.
- Updated financial information for Microsoft



Chapter 15: Money and the Financial System

- New boxed features describing current financial issues
- Updated life expectancy of money
- Updated cost to produce coins
- New content on cryptocurrency
- New See for Yourself Videocase-Kiva

Chapter 16: Financial Management and Securities Markets

- New boxed features describing current financial issues
- Updated short-term investment possibilities
- Updated U.S. corporate bond quotes
- New content on electronic markets

Acknowledgments

The twelfth edition of Business Foundations: A Changing World would not have been possible without the commitment, dedication, and patience of Jennifer Sawayda and Kelsey Reddick. Kelsey Reddick provided oversight for editing text content, and Jennifer Sawayda developed the cases, boxes, and the supplements. Anke Weekes, Executive Brand Manager, provided leadership and creativity in planning and implementing all aspects of the twelfth edition. Haley Burmeister, Product Developer, did an outstanding job of coordinating all aspects of the development and production process. Kathryn Wright was the Content Project Manager. Bruce Gin managed the technical aspects of Connect. Others important in this edition include Gabe Fedota (Marketing Manager) and Jessica Cuevas (Designer). Michael Hartline developed the Personal Career Plan in Appendix B. Vickie Bajtelsmit developed Bonus Chapter B on personal financial planning. Eric Sandberg of Interactive Learning assisted in developing the interactive exercises. Many others have assisted us with their helpful comments, recommendations, and support throughout this and previous editions. Thank you for all of your insight and feedback. We'd like to express our sincere thanks to the reviewers who helped us shape the twelfth edition. Your time and thoughtful feedback has helped us greatly make this another great revision:

Michael Bento

Owens Community College

Patty Boyle

Lane Community College

Dennis Brode

Sinclair Community College

Angela Casler

California State University

Steven M. Dunphy

Indiana University Northwest

Terri Gonzalez-Kreisman

Delgado Community College

Chad Grooms

Gateway Community and Technical College

Ivan Franklin Harber Jr.

Indian River State College

Dan Jones

Ball State University

Stephen Konrad

Portland State University

Hui Pate

Skyline College

Daniel Pfaltzgraf

University of Toledo

Linda L. Ridley

CUNY Hostos Community College

Michael Rose

Butler Community College

Amanda Stocklein

State Fair Community College

Rhonda K. Thomas

Butler Community College

Bruce Yuille

Mid Michigan Community College



Brenda Anthony, Tallahassee Community College NaRita Gail Anderson, University of Central Oklahoma

Phyllis Alderdice, Jefferson Community College Vondra Armstrong, Pulaski Tech College John Bajkowski, American Association of Individual Investors

Gene Baker, *University of North Florida*Lia Barone, *Norwalk Community College*Ellen Benowitz, *Mercer County Community College*Stephanie Bibb, *Chicago State University*

Gene Blackmun, Rio Hondo College

Susan Blumen, Montgomery College

Barbara Boyington, Monmouth–Ocean County Small Business Development Center

Suzanne Bradford, Angelina College

Alka Bramhandkar, *Ithaca College*

Dennis Brode, Sinclair Community College

Harvey S. Bronstein, Oakland Community College

Colin Brooks, *University of New Orleans*

Eric Brooks, Orange County Community College

Nicky Buenger, Texas A&M University

Anthony Buono, Bentley College

Tricia Burns, Boise State University

Diana Carmel, Golden West College

William Chittenden, Texas State University

Michael Cicero, Highline Community College

Margaret Clark, Cincinnati State Tech & Community College

Mark Lee Clark, Collin College

Debbie Collins, Anne Arundel Community College–Arnold

Karen Collins, Lehigh University

Katherine Conway, Borough of Manhattan Community College

Rex Cutshall, *Indiana University*

Dana D'Angelo, Drexel University

Laurie Dahlin, Worcester State College

Deshaun H. Davis, *Northern Virginia Community College*

Yalonda Ross Davis, Grand Valley State University

Peter Dawson, Collin County Community
College–Plano

John DeNisco, Buffalo State College

Tom Diamante, Corporate Consulting Associates, Inc.

Joyce Domke, DePaul University

Glenn Doolittle, Santa Ana College

Michael Drafke, College of DuPage

John Eagan, Erie Community College/City Campus SUNY

Glenda Eckert, Oklahoma State University

Thomas Enerva, University of Maine-Fort Kent

Robert Ericksen, Business Growth Center

Donna Everett, Santa Rosa Junior College

Joe Farinella, *University of North*

Carolina-Wilmington

Bob Farris, Mt. San Antonio College

Gil Feiertag, Columbus State Community College

James Ferrell, R. G. Taylor, P.C.

Cheryl Fetterman, Cape Fear Community College

Art Fischer, Pittsburg State University

Jackie Flom, University of Toledo

Anthony D. Fontes III, *Bunker Hill Community College*

Jennifer Friestad, Anoka–Ramsey Community College Chris Gilbert, Tacoma Community College/University of Washington

Ross Gittell, University of New Hampshire

Connie Golden, *Lakeland Community College* Terri Gonzales-Kreisman, *Phoenix College*

Terri Gonzales-Kielsman, Fnoema Conlege

Kris Gossett, Ivy Tech Community College of Indiana

Carol Gottuso, Metropolitan Community College

Bob Grau, Cuyahoga Community College–Western Campus

Gary Grau, Northeast State Tech Community College Jack K. Gray, Attorney-at-Law, Houston, Texas Catherine Green, University of Memphis

Claudia Green, Pace University

Maurice P. Greene, Monroe College

Phil Greenwood, University of Wisconsin-Madison

David Gribbin, East Georgia College

Selina Andrea Griswold, University of Toledo

John P. Guess, Delgado Community College

Peggy Hager, Winthrop University

Michael Hartline, Florida State University

Paul Harvey, University of New Hampshire

Neil Herndon, University of Missouri

James Hoffman, *Borough of Manhattan Community College*

MaryAnne Holcomb, Antelope Valley College

Timothy D. Hovet, Lane Community College

Joseph Hrebenak, Community College of Allegheny

County-Allegheny Campus

Stephen Huntley, Florida Community College

Rebecca Hurtz, State Farm Insurance Co.

Donald C. Hurwitz, Austin Community College

Scott Inks, Ball State University

Steven Jennings, Highland Community College

Carol Jones, Cuyahoga Community College–Eastern

Campus



Sandra Kana, Mid-Michigan Community College Norm Karl, Johnson County Community College Janice Karlan, LaGuardia Community College Eileen Kearney, Montgomery County Community College

Craig Kelley, California State University— Sacramento

Susan Kendall, Arapahoe Community College Ina Midkiff Kennedy, Austin Community College Kathleen Kerstetter, Kalamazoo Valley Community College

Arbrie King, Baton Rouge Community College John Knappenberger, Mesa State College Gail Knell, Cape Cod Community College Anthony Koh, *University of Toledo* Regina Korossy, *Pepperdine University* Velvet Landingham, Kent State University-Geauga Jeffrey Lavake, University of Wisconsin-Oshkosh Daniel LeClair, AACSB

Chad T. Lewis, Everett Community College Richard Lewis, East Texas Baptist College Corinn Linton, Valencia Community College

Corrine Livesay, *Mississippi College*

Thomas Lloyd, Westmoreland Community College

Terry Loe, Kennerow University

Terry Lowe, *Illinois State University* Kent Lutz, *University of Cincinnati*

Scott Lyman, Winthrop University

Dorinda Lynn, Pensacola Junior College

Isabelle Maignan, *ING*

Larry Martin, Community College of Southern Nevada–West Charles

Therese Maskulka, Youngstown State University Theresa Mastrianni, Kingsborough Community College

Kristina Mazurak, Albertson College of Idaho Debbie Thorne McAlister, Texas State University-San Marcos

Noel McDeon, Florida Community College John McDonough, Menlo College

Tom McInish, *University of Memphis* Mark McLean, Delgado Community College

Chris Mcnamara, Fingers Lake Community College

Kimberly Mencken, Baylor University

Mary Meredith, University of Louisiana at Lafayette

Michelle Meyer, Joliet Junior College

George Milne, University of Massachusetts-Amherst

Daniel Montez, South Texas College

Glynna Morse, Augusta College

Suzanne Murray, Piedmont Technical College

Stephanie Narvell, Wilmington College-New Castle Fred Nerone, International College of Naples Laura Nicholson, Northern Oklahoma College Stef Nicovich, Lynchburg College Michael Nugent, SUNY-Stony Brook University New York

Mark Nygren, Brigham Young University-Idaho Lauren Paisley, Genesee Community College James Patterson, Paradise Valley Community College Wes Payne, Southwest Tennessee Community College Dyan Pease, Sacramento City College

Constantine G. Petrides, Borough of Manhattan Community College

John Pharr, Cedar Valley College

Shirley Polejewski, University of St. Thomas

Daniel Powroznik, Chesapeake College

Krista Price, Heald College

Larry Prober, Rider University

Vincent Quan, Fashion Institute Technology

Michael Quinn, Penn State University

Stephen Pruitt, University of Missouri–Kansas City

Victoria Rabb, College of the Desert

Gregory J. Rapp, Portland Community College

Tom Reading, Ivy Tech State College

Delores Reha, Fullerton College

David Reiman, Monroe County Community College

Susan Roach, Georgia Southern University Dave Robinson, *University of California–Berkeley*

Carol Rowey, Surry Community College

Marsha Rule, Florida Public Utilities Commission

Carol A. Rustad, Sylvan Learning

Cyndy Ruszkowski, *Illinois State University*

Martin St. John, Westmoreland Community College

Don Sandlin, East Los Angeles College

Nick Sarantakes, Austin Community College

Andy Saucedo, Dona Ana Community College-Las Cruces

Dana Schubert, Colorado Springs Zoo

Marianne Sebok, Community College of Southern Nevada–West Charles

Jeffery L. Seglin, Seglin Associates

Daniel Sherrell, University of Memphis

Morgan Shepherd, University of Colorado Elaine Simmons, Guilford Technical Community College

Greg Simpson, Blinn College

Nicholas Siropolis, Cuyahoga Community College

Robyn Smith, Pouder Valley Hospital

Kurt Stanberry, University of Houston Downtown

Cheryl Stansfield, North Hennepin Community

College

Ron Stolle, Kent State University–Kent
Edith Strickland, Tallahassee Community College
Jeff Strom, Virginia Western Community College
Lisa Strusowski, Tallahassee Community College
Scott Taylor, Moberly Area Community College
Wayne Taylor, Trinity Valley Community College
Ray Tewell, American River College
Rodney Thirion, Pikes Peak Community College
Evelyn Thrasher, University of

Massachusetts—Dartmouth
Steve Tilley, Gainesville College
Amy Thomas, Roger Williams University
Kristin Trask, Butler Community College
Allen D. Truell, Ball State University

George Valcho, Bossier Parish Community College
Ted Valvoda, Lakeland Community College
Gunnar Voltz, Northern Arizona University–Flagstaff
Sue Vondram, Loyola University
Elizabeth Wark, Springfield College
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Elisabeth Wicker, Bossier Parish Community College
Frederik Williams, North Texas State University
Richard Williams, Santa Clara University
Pat Wright, University of South Carolina
Lawrence Yax, Pensacola Junior College–Warrington
Bruce Yuille, Cornell University–Ithaca



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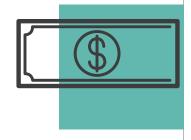


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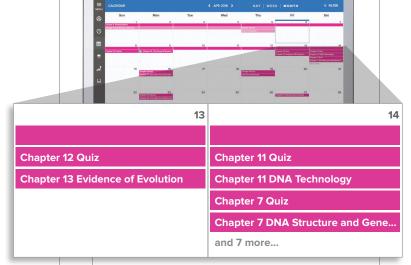


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> - Jordan Cunningham, Eastern Washington University

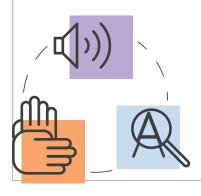
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Chapter 1 The Dynamics of Business and Economics

Chapter 2 Business Ethics and Social Responsibility

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The Role of Government in the

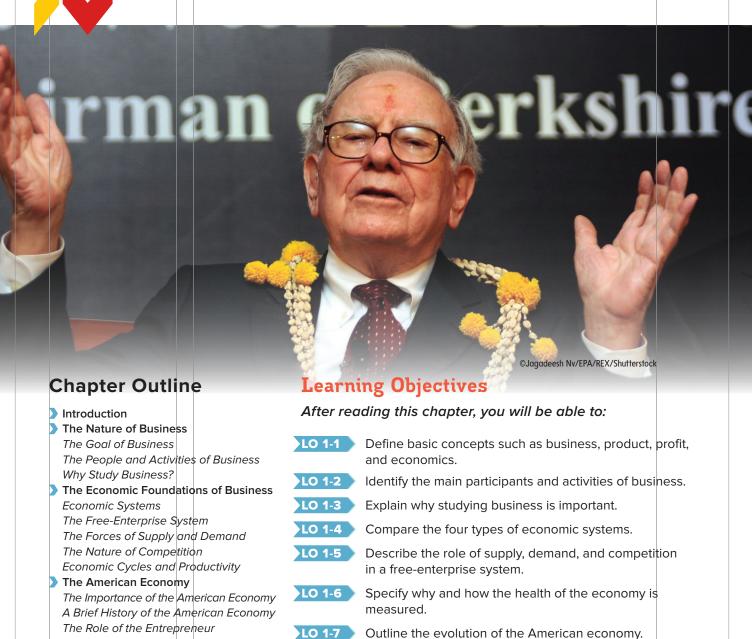
The Role of Ethics and Social

Can You Learn Business in a Classroom?

Responsibility in Business

American Economy

The Dynamics of Business and Economics



LO 1-8

LO 1-9

Explain the role of the entrepreneur in the economy.

Evaluate a small-business owner's situation and

propose a course of action.

Enter the World of Business

Warren Buffet: The Oracle of Omaha

Warren Buffett did not change his life plans when he was rejected by Harvard. An avid reader with a photographic memory, he persevered. He researched other universities and discovered that Benjamin Graham, the author of the *The Intelligent Investor*, was a professor at Columbia University. He immediately enrolled there, was accepted, and became the star pupil and eventual partner of the famous Graham. After graduating, Buffett started a lucrative career, taking ownership in companies that he believed would do well in business.

Buffett's company, Berkshire Hathaway, has become a conglomerate with ownership in well-performing companies, including Geico, Heinz, Benjamin Moore, and See's Candies. Because Berkshire Hathaway owns companies in so many different industries, it reduces the risk that the failure of any one industry will significantly affect the company. Most importantly, Buffett believes in these firms and their value, a strategy that has made him one of the 10 richest people in the world.

Leading such a variety of companies comes with challenges as well. Companies require leaders who know the business and have specialized expertise—something nearly impossible for one person to do with so many different business areas. For this reason, Buffett depends on his managers to lead the various companies. He believes giving his managers autonomy allows them to achieve their highest performance. He wants his managers to "own" their job. By hiring knowledgeable managers and empowering them to run the companies as they believe best, Buffett is able to lead his vast business conglomerate successfully.

Buffett's organizational leadership philosophy includes focusing on the business. At his headquarters, 25 people run the organization. He encourages entrepreneurs "to focus on the business and not growing a large staff." Buffett has earned the moniker "Oracle of Omaha" because he has lived there most of his life and many investors follow his advice and decisions. 1



Define basic concepts such as business, product, profit, and economics.

business

individuals or organizations who try to earn a profit by providing products that satisfy people's needs.

product

a good or service with tangible and intangible characteristics that provide satisfaction and benefits.

profit

the difference between what it costs to make and sell a product and what a customer pays for it.

nonprofit organizations

organizations that may provide goods or services but do not have the fundamental purpose of earning profits.

Introduction

We begin our study of business in this chapter by examining the fundamentals of business and economics. First, we introduce the nature of business, including its goals, activities, and participants. Next, we describe the basics of economics and apply them to the U.S. economy. Finally, we establish a framework for studying business in this text.

The Nature of Business

A **business** tries to earn a profit by providing products that satisfy people's needs. The outcomes of its efforts are **products** that have both tangible and intangible characteristics that provide satisfaction and benefits. When you purchase a product, you are buying the benefits and satisfaction you think the product will provide. A Subway sandwich, for example, may be purchased to satisfy hunger, while a Honda Accord may be purchased to satisfy the need for transportation and the desire to present a certain image.

Most people associate the word *product* with tangible goods—an automobile, smartphone, jeans, or some other tangible item. However, a product can also be a service, which occurs when people or machines provide or process something of value to customers. Dry cleaning, a checkup by a doctor, a movie or sports event—these are examples of services. An Uber ride satisfies the need for transportation and is therefore a service. A product can also be an idea. Accountants and attorneys, for example, provide ideas for solving problems.

The Goal of Business

The primary goal of all businesses is to earn a **profit**, the difference between what it costs to make and sell a product and what a customer pays for it. In addition, a business has to pay for all expenses necessary to operate. If a company spends \$8 to produce, finance, promote, and distribute a product that it sells for \$10, the business earns a profit of \$2 on each product sold. Businesses have the right to keep and use their profits as they choose—within legal limits—because profit is the reward for their efforts and for the risks they take in providing products. Earning profits contributes to society by creating resources that support our social institutions and government. Businesses that create profits, pay taxes, and create jobs are the foundation of our economy. In addition, profits must be earned in a responsible manner. Not all organizations are businesses, however. **Nonprofit organizations**—such as National Public Radio (NPR), Habitat for Humanity, and other charities and social causes—do not have the fundamental purpose of earning profits, although they may provide goods or services and engage in fund-raising. They also utilize skills related to management, marketing, and finance. Profits earned by businesses support nonprofit organizations through donations from employees.

To earn a profit, a person or organization needs management skills to plan, organize, and control the activities of the business and to find and develop employees so that it can make products consumers will buy. A business also needs marketing expertise to learn what products consumers need and want and to develop, manufacture, price, promote, and distribute those products. Additionally, a business needs financial resources and skills to fund, maintain, and expand its operations. A business must cover the cost of labor, operate facilities, pay taxes, and provide management. Other challenges for businesspeople include abiding by laws and government regulations, and adapting to economic, technological, political, and social changes. Even non-profit organizations engage in management, marketing, and finance activities to help reach their goals.



Sustainability is a growing concern among both consumers and businesses. Microsoft recently completed the single largest corporate purchase of solar energy ever in the United States.

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To achieve and maintain profitability, businesses have found that they must produce quality products, operate efficiently, and be socially responsible and ethical in dealing with customers, employees, investors, government regulators, and the community. Because these groups have a stake in the success and outcomes of a business, they are sometimes called **stakeholders**. Many businesses, for example, are concerned about how the production and distribution of their products affect the environment. New fuel requirements are forcing automakers to invest in smaller, lightweight cars. Electric vehicles may be a solution, but only about 1 percent of new car sales are plug-in-electric. Other businesses are concerned with promoting science, engineering, and mathematics careers among women. Traditionally, these careers have been male dominated. A global survey found that when the number of men and women were evenly matched, the team was 23 percent more likely to have an increase in profit over teams dominated by one gender. Nonprofit organizations, such as the American Red Cross, use business activities to support natural-disaster victims, relief efforts, and a national blood supply.

The People and Activities of Business

Figure 1.1 shows the people and activities involved in business. At the center of the figure are owners, employees, and customers; the outer circle includes the primary business activities—management, marketing, and finance. Owners have to put up resources—money or credit—to start a business. Employees are responsible for the work that goes on within a business. Owners can manage the business themselves or hire employees to accomplish this task. The president and chief executive officer (CEO) of Procter & Gamble, David S. Taylor, does not own P&G but is an employee who is responsible for managing all the other employees in a way that earns a profit for investors, who are the real owners. Finally, and most importantly, a business's major role is to satisfy the customers who buy its goods or services. Note also that forces beyond an organization's control—such as legal and regulatory forces, the economy, competition, technology, the political environment, and ethical and social concerns—all have an impact on the daily operations of businesses. You will learn more about these participants in business activities throughout this book. Next, we will examine the major activities of businesss.

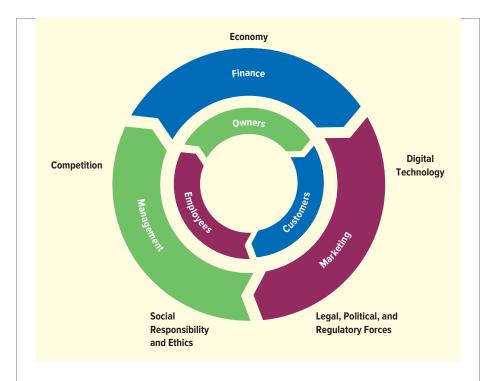
stakeholders

groups that have a stake in the success and outcomes of a business.

LO 1-2

Identify the main participants and activities of business.

FIGURE 1.1
Overview of the Business
World



Management. Notice that in Figure 1.1, management and employees are in the same segment of the circle. This is because management involves developing plans, coordinating employees' actions to achieve the firm's goals, organizing people to work efficiently, and motivating them to achieve the business's goals. Management involves the functions of planning, organizing, leading, and controlling. Effective managers who are skilled in these functions display effective leadership, decision making, and delegation of work tasks. Management is also concerned with acquiring, developing, and using resources (including people) effectively and efficiently.

Operations is another element of management. Managers must oversee the firm's operations to ensure that resources are successfully transformed into goods and services. Although most people associate operations with the development of goods, operations management applies just as strongly to services. Managers at the Ritz-Carlton, for instance, are concerned with transforming resources such as employee actions and hotel amenities into a quality customer service experience. In essence, managers plan, organize, staff, and control the tasks required to carry out the work of the company or nonprofit organization. We take a closer look at management activities in Parts 3 and 4 of this text.

Marketing. Marketing and customers are in the same segment of Figure 1.1 because the focus of all marketing activities is satisfying customers. Marketing includes all the activities designed to provide goods and services that satisfy consumers' needs and wants. Marketers gather information and conduct research to determine what customers want. Using information gathered from marketing research, marketers plan and develop products and make decisions about how much to charge for their products and when and where to make them available. They also

analyze the marketing environment to understand changes in competition and consumers. The retail environment is changing based on competition from online retailing such as Amazon. This has caused some retail stores and malls to close.⁴ Marketing focuses on the four P's—product, price, place (or distribution), and promotion—also known as the marketing mix. Product management involves such key management decisions as product adoption, development, branding, and product positioning. Selecting the right price for the product is essential to the organization as it relates directly to profitability. Distribution is an important management concern because it involves making sure products are available to consumers in the right place at the right time. Supply chain management involves purchasing and logistics as well as operations to



M&Ms uses humor in its advertising to promote the chocolate candies.

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coordinate suppliers, producers, and distributors to create value for customers. Marketers use promotion—advertising, personal selling, sales promotion (coupons, games, sweepstakes, movie tie-ins), and publicity—to communicate the benefits and advantages of their products to consumers and to increase sales. We will examine marketing activities in Part 5 of this text.

Finance. Owners and finance are in the same part of Figure 1.1 because, although management and marketing have to deal with financial considerations, it is the primary responsibility of the owners to provide financial resources for the operation of the business. Moreover, the owners have the most to lose if the business fails to make a profit. Finance refers to all activities concerned with obtaining money and using it effectively. People who work as accountants, stockbrokers, investment advisors, or bankers are all part of the financial world. Owners sometimes have to borrow money from banks to get started or attract additional investors who become partners or stockholders. Owners of small businesses in particular often rely on bank loans for funding. Part 6 of this text discusses financial management.

Why Study Business?

Studying business can help you develop skills and acquire knowledge to prepare for your future career, regardless of whether you plan to work for a multinational *Fortune* 500 firm, start your own business, work for a government agency, or manage or volunteer at a nonprofit organization. The field of business offers a variety of interesting and challenging career opportunities throughout the world, such as marketing, human resources management, information technology, finance, production, accounting, data analytics, and many more.

Studying business can also help you better understand the many business activities that are necessary to provide satisfying goods and services. Most businesses charge a reasonable price for their products to ensure that they cover their production costs, pay their employees, provide their owners with a return on their investment, and perhaps give something back to their local communities and societies. Habitat for Humanity is an international nonprofit organization building housing for those who cannot afford simple, decent housing. Habitat operates like a business relying on volunteer labor and



Explain why studying business



Many companies engage in socially responsible behavior to give back to their communities. Bank of America partners with Habitat for Humanity to build homes for disadvantaged families.

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Compare the four types of economic systems.

economics

the study of how resources are distributed for the production of goods and services within a social system.

natural resources

land, forests, minerals, water, and other things that are not made by people.

human resources (labor)

the physical and mental abilities that people use to produce goods and services.

financial resources (capital)

the funds used to acquire the natural and human resources needed to provide products.

economic system

a description of how a particular society distributes its resources to produce goods and services. offers no-interest mortgages for repayment. Habitat ReStore is a retail unit that sells new and used building materials that are donated. The Home Depot Foundation has provided grants to remodel and renovate homes of U.S. military veterans.⁵ Thus, learning about business can help you become a well-informed consumer and member of society.

Business activities help generate the profits that are essential not only to individual businesses and local economies, but also to the health of the global economy. Without profits, businesses find it difficult, if not impossible, to buy more raw materials, hire more employees, attract more capital, and create additional products that, in turn, make more profits and fuel the world economy. Understanding how our free-enterprise economic system allocates resources and provides incentives for industry and the work-place is important to everyone.

The Economic Foundations of Business

It is useful to explore the economic environment in which business is conducted. In this section, we examine economic systems, the free-enterprise system, the concepts of supply and demand, and the role of competition. These concepts play important roles in determining how businesses operate in a particular society.

Economics is the study of how resources are distributed for the production of goods and services within a social system. You are already familiar with the types of resources available. Land, forests, minerals, water, and other things that are not made by people are **natural resources**. **Human resources**, or **labor**, refer to the physical and mental abilities that people use to produce goods and services. **Financial resources**, or **capital**, are the funds used to acquire the natural and human resources needed to provide products. These resources are related to the *factors of production*, consisting of land, labor, capital, and enterprise used to produce goods and services. The firm can also have intangible resources such as a good reputation for quality products or being socially responsible. The goal is to turn the factors of production and intangible resources into a competitive advantage.

Economic Systems

An **economic system** describes how a particular society distributes its resources to produce goods and services. A central issue of economics is how to fulfill an unlimited demand for goods and services in a world with a limited supply of resources. Different economic systems attempt to resolve this central issue in numerous ways, as we shall see.

Although economic systems handle the distribution of resources in different ways, all economic systems must address three important issues:

- 1. What goods and services, and how much of each, will satisfy consumers' needs?
- 2. How will goods and services be produced, who will produce them, and with what resources will they be produced?
- 3. How are the goods and services to be distributed to consumers?

	Communism	Socialism	Capitalism
Business ownership	Most businesses are owned and operated by the government.	The government owns and operates some basic industries; individuals own small businesses.	Individuals own and operate all businesses.
Competition	Government controls competition and the economy.	Restricted in basic industries; encouraged in small business.	Encouraged by market forces and government regulations.
Profits	Excess income goes to the government. The government supports social and economic institutions.	Profits earned by small businesses may be reinvested in the business; profits from government- owned industries go to the government.	Individuals and businesses are free to keep profits after paying taxes.
Product availability and price	Consumers have a limited choice of goods and services; prices are usually high.	Consumers have some choice of goods and services; prices are determined by supply and demand.	Consumers have a wide choice of goods and services; prices are determined by supply and demand.
Employment options	Little choice in choosing a career; most people work for government-owned industries or farms.	More choice of careers; many people work in government jobs.	Unlimited choice of careers.

TABLE 1.1
Comparison of
Communism, Socialism,
and Capitalism

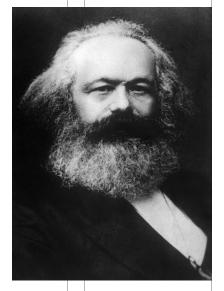
communism

first described by Karl Marx as a society in which the people, without regard to class, own all the nation's resources.

Communism, socialism, and capitalism, the basic economic systems found in the world today (Table 1.1), have fundamental differences in the way they address these issues. The factors of production in command economies are controlled by government planning. In many cases, the government owns or controls the production of goods and services. Communism and socialism are, therefore, considered command economies.

Communism. Karl Marx (1818–1883) first described **communism** as a society in which the people, without regard to class, own all the nation's resources. In his ideal political-economic system, everyone contributes according to ability and receives benefits according to need. In a communist economy, the people (through the government) own and operate all businesses and factors of production. Central government planning determines what goods and services satisfy citizens' needs, how the goods and services are produced, and how they are distributed. However, no true communist economy exists today that satisfies Marx's ideal.

On paper, communism appears to be efficient and equitable, producing less of a gap between rich and poor. In practice, however, communist economies have been marked by low standards of living, critical shortages of consumer goods, high prices, corruption, and little freedom. Russia, Poland, Hungary, and other eastern European nations have



Karl Marx, the founder of communism, described a society in which the people own all of the nation's resources and contribute according to their ability.

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socialism

an economic system in which the government owns and operates basic industries but individuals own most businesses.

capitalism (free enterprise)

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

free-market system

pure capitalism, in which all economic decisions are made without government intervention.

turned away from communism and toward economic systems governed by supply and demand rather than by central planning. However, their experiments with alternative economic systems have been fraught with difficulty and hardship. Countries such as Venezuela have tried to incorporate communist economic principles without success. Even Cuba is experiencing changes to its predominately communist system. Massive government layoffs required many Cubans to turn toward the private sector, opening up more opportunities for entrepreneurship. The U.S. government has reestablished diplomatic relations with Cuba. Americans have more opportunities to visit Cuba than they have had for the past 50 years. Similarly, China has become the first communist country to make strong economic gains by adopting capitalist approaches to business. Economic prosperity has advanced in China with the government claiming to ensure market openness, equality, and fairness through state capitalism.⁶ As a result of economic challenges, communism is declining and its future as an economic system is uncertain.

Socialism. Socialism is an economic system in which the government owns and operates basic industries—postal service, telephone, utilities, transportation, health care, banking, and some manufacturing—but individuals own most businesses. For example, in France the postal service industry La Poste is fully owned by the French government and makes a profit. Central planning determines what basic goods and services are produced, how they are produced, and how they are distributed. Individuals and small businesses provide other goods and services based on consumer demand and the availability of resources. Citizens are dependent on the government for many goods and services.

Most socialist nations, such as Norway, India, and Israel, are democratic and recognize basic individual freedoms. Citizens can vote for political offices, but central government planners usually make many decisions about what is best for the nation. People are free to go into the occupation of their choice, but they often work in government-operated organizations. Socialists believe their system permits a higher standard of living than other economic systems, but the difference often applies to the nation as a whole rather than to its individual citizens. Socialist economies profess egalitarianism—equal distribution of income and social services. They believe

their economies are more stable than those of other nations. Although this may be true, taxes and unemployment are generally higher in socialist countries. However, countries like Denmark have a high standard of living and they rate high in being happy.

Capitalism. Capitalism, or free enterprise, is an economic system in which individuals own and operate the majority of businesses that provide goods and services. Competition, supply, and demand determine which goods and services are produced, how they are produced, and how they are distributed. The United States, Canada, Japan, and Australia are examples of economic systems based on capitalism.

There are two forms of capitalism: pure capitalism and modified capitalism. In pure capitalism, also called a **free-market system**, all economic decisions are made without government intervention.



Cuba and the United States restored diplomatic relations, and as a result, there are more opportunities to visit and do business with Cuba.

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This economic system was first described by Adam Smith in *The Wealth of Nations* (1776). Smith, often called the father of capitalism, believed that the "invisible hand of competition" best regulates the economy. He argued that competition should determine what goods and services people need. Smith's system is also called *laissez-faire* ("let it be") *capitalism* because the government does not interfere in business.

Modified capitalism differs from pure capitalism in that the government intervenes and regulates business to some extent. One of the ways in which the United States and Canadian governments regulate business is through laws. Laws such as the Federal Trade Commission Act, which created the Federal Trade Commission to enforce antitrust laws, illustrate the importance of the government's role in the economy. In the United States, states have leeway to regulate business. For example, the state of Washington requires employers to provide paid sick leave, and a number of states have legalized cannabis.⁷

Mixed Economies. No country practices a pure form of communism, socialism, or capitalism, although most tend to favor one system over the others. Most nations operate as **mixed economies**, which have elements from more than one economic system. In socialist Sweden, most businesses are owned and operated by private individuals. In capitalist United States, an independent federal agency operates the postal service and another independent agency operates the Tennessee Valley Authority, an electric utility. In Great Britain and Mexico, the governments are attempting to sell many state-run businesses to private individuals and companies. In Germany, the Deutsche Post is privatized and trades on the stock market. In once-communist Russia, Hungary, Poland, and other eastern European nations, capitalist ideas have been implemented, including private ownership of businesses.

Countries such as China and Russia have used state capitalism to advance the economy. State capitalism tries to integrate the powers of the state with the advantages of capitalism. It is led by the government but uses capitalistic tools such as listing state-owned companies on the stock market and embracing globalization. State capitalism includes some of the world's largest companies such as Russia's Gazprom, which has the largest reserves of natural gas. China's ability to make huge investments to the point of creating entirely new industries puts many private industries at a disadvantage.

The Free-Enterprise System

Many economies—including those of the United States, Canada, and Japan—are based on free enterprise, and many communist and socialist countries, such as China and Russia, are applying more principles of free enterprise to their own economic systems. Free enterprise provides an opportunity for a business to succeed or fail on the basis of market demand. In a free-enterprise system, companies that can efficiently manufacture and sell products that consumers desire will probably succeed. Inefficient businesses and those that sell products that do not offer needed benefits will likely fail as consumers take their business to firms that have more competitive products.

A number of basic individual and business rights must exist for free enterprise to work. These rights are the goals of many countries that have recently embraced free enterprise.

- 1. Individuals must have the right to own property and to pass this property on to their heirs. This right motivates people to work hard and save to buy property.
- 2. Individuals and businesses must have the right to earn profits and to use the profits as they wish, within the constraints of their society's laws, principles, and values.

mixed economies

economies made up of elements from more than one economic system.



Two entrepreneurs present an idea for a new product. Entrepreneurs are more productive in free-enterprise systems.

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- 3. Individuals and businesses must have the right to make decisions that determine the way the business operates. Although there is government regulation, the philosophy in countries like the United States and Australia is to permit maximum freedom within a set of rules of fairness.
- 4. Individuals must have the right to choose what career to pursue, where to live, what goods and services to purchase, and more. Businesses must have the right to choose where to locate, what goods and services to produce, what resources to use in the production process, and so on.

Without these rights, businesses cannot function effectively because they are not motivated to succeed. Thus, these rights make possible the open exchange of goods and services. In the countries that favor free enterprise, such as the United

States, citizens have the freedom to make many decisions about the employment they choose and create their own productivity systems. Many entrepreneurs are more productive in free-enterprise societies because personal and financial incentives are available that can aid in entrepreneurial success. For many entrepreneurs, their work becomes a part of their system of goals, values, and lifestyle. Consider the panelists ("sharks") on the ABC program *Shark Tank* who give entrepreneurs a chance to receive funding to realize their dreams by deciding whether to invest in their projects. They include Barbara Corcoran, who built one of New York's largest real estate companies; Mark Cuban, founder of Broadcast.com and MicroSolutions; and Daymond John, founder of clothing company FUBU, as well as others. 10

The Forces of Supply and Demand

In the United States and in other free-enterprise systems, the distribution of resources and products is determined by supply and demand. **Demand** is the number of goods and services that consumers are willing to buy at different prices at a specific time. From your own experience, you probably recognize that consumers are usually willing to buy more of an item as its price falls because they want to save money. Consider handmade rugs, for example. Consumers may be willing to buy six rugs at \$350 each, four at \$500 each, but only two at \$650 each. The relationship between the price and the number of rugs consumers are willing to buy can be shown graphically with a *demand curve* (see Figure 1.2).

Supply is the number of products that businesses are willing to sell at different prices at a specific time. In general, because the potential for profits is higher, businesses are willing to supply more of a good or service at higher prices. For example, a company that sells rugs may be willing to sell six at \$650 each, four at \$500 each, but just two at \$350 each. The relationship between the price of rugs and the quantity the company is willing to supply can be shown graphically with a *supply curve* (see Figure 1.2).

In Figure 1.2, the supply and demand curves intersect at the point where supply and demand are equal. The price at which the number of products that businesses are willing to supply equals the amount of products that consumers are willing to buy at

demand

the number of goods and services that consumers are willing to buy at different prices at a specific time.



Describe the role of supply, demand, and competition in a free-enterprise system.

supply

the number of products goods and services—that businesses are willing to sell at different prices at a specific time.

connect •



Need help understanding supply and demand? Visit your Connect ebook video tab for a brief animated explanation.

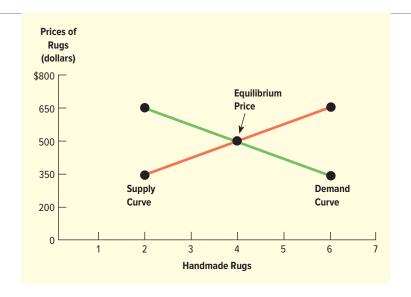


FIGURE 1.2 Equilibrium Price of Handmade Rugs

a specific point in time is the **equilibrium price**. In our rug example, the company is willing to supply four rugs at \$500 each, and consumers are willing to buy four rugs at \$500 each. Therefore, \$500 is the equilibrium price for a rug at that point in time, and most rug companies will price their rugs at \$500. As you might imagine, a business that charges more than \$500 (or whatever the current equilibrium price is) for its rugs will not sell as many and might not earn a profit. On the other hand, a business that charges less than \$500 accepts a lower profit per rug than could be made at the equilibrium price.

If the cost of making rugs goes up, businesses will not offer as many at the old price. Changing the price alters the supply curve, and a new equilibrium price results. This is an ongoing process, with supply and demand constantly changing in response to changes in economic conditions, availability of resources, and degree of competition. For example, the price of oil can change rapidly and has been between \$30 and \$113 a barrel over the last eight years. Prices for goods and services vary according to these changes in supply and demand. Supply and demand is the force that drives the distribution of resources (goods and services, labor, and money) in a free-enterprise economy.

Critics of supply and demand say the system does not distribute resources equally. The forces of supply and demand prevent sellers who have to sell at higher prices (because their costs are high) and buyers who cannot afford to buy goods at the equilibrium price from participating in the market. According to critics, the wealthy can afford to buy more than they need, but the poor may be unable to buy enough of what they need to survive.

The Nature of Competition

Competition, the rivalry among businesses for consumers' dollars, is another vital element in free enterprise. According to Adam Smith, competition fosters efficiency and low prices by forcing producers to offer the best products at the most reasonable price; those who fail to do so are not able to stay in business. Thus, competition should improve the quality of the goods and services available and reduce prices. Competition allows for open markets and provides opportunities for both individuals and businesses to successfully compete. Entrepreneurs can discover new technology,

equilibrium price

the price at which the number of products that businesses are willing to supply equals the amount of products that consumers are willing to buy at a specific point in time.

competition

the rivalry among businesses for consumers' dollars.

pure competition

the market structure that exists when there are many small businesses selling one standardized product.

monopolistic competition

the market structure that exists when there are fewer businesses than in a purecompetition environment and the differences among the goods they sell are small.

oligopoly

the market structure that exists when there are very few businesses selling a product.

monopoly

the market structure that exists when there is only one business providing a product in a given market. ways to lower prices, as well as methods for providing better distribution or services. Founder Jeff Bezos of Amazon is a prime example. Amazon was able to offer products online at competitive prices. Today, Amazon competes against such retail giants as Walmart in a number of industries, including cloud computing, entertainment, food, and most consumer products found in retail stores. Bezos is now the richest person in the world.

Within a free-enterprise system, there are four types of competitive environments: pure competition, monopolistic competition, oligopoly, and monopoly.

Pure competition exists when there are many small businesses selling one standardized product, such as agricultural commodities like wheat, corn, and cotton. No one business sells enough of the product to influence the product's price. And, because there is no difference in the products, prices are determined solely by the forces of supply and demand.

Monopolistic competition exists when there are fewer businesses than in a pure-competition environment and the differences among the goods they sell are small. Aspirin, soft drinks, and jeans are examples of such goods. These products differ slightly in packaging, warranty, name, and other characteristics, but all satisfy the same consumer need. Businesses have some power over the price they charge in monopolistic competition because they can make consumers aware of product differences through advertising. Consumers value some features more than others and are often willing to pay higher prices for a product with the features they want. For example, many consumers are willing to pay a higher price for organic fruits and vegetables rather than receive a bargain on nonorganic foods. The same holds true for non-genetically modified foods.

An oligopoly exists when there are very few businesses selling a product. In an oligopoly, individual businesses have control over their products' price because each business supplies a large portion of the products sold in the marketplace. Nonetheless, the prices charged by different firms stay fairly close because a price cut or increase by one company will trigger a similar response from another company. In the airline industry, for example, when one airline cuts fares to boost sales, other airlines quickly follow with rate decreases to remain competitive. On the other hand, airlines often raise prices at the same time. Oligopolies exist when it is expensive for new firms to enter the marketplace. Not just anyone can acquire enough financial capital to build an automobile production facility or purchase enough airplanes and related resources to build an airline.

When there is one business providing a product in a given market, a monopoly exists. Utility companies that supply electricity, natural gas, and water are monopolies. The government permits such monopolies because the cost of creating the good or supplying the service is so great that new producers cannot compete for sales. Government-granted monopolies are subject to government-regulated prices. Some monopolies exist because of technological developments that are protected by patent laws. Patent laws grant the developer of new technology a period of time (17 or 20 years) during which no other producer can use the same technology without the agreement of the original developer. The United States granted its first patent in 1790. Now its patent office receives hundreds of thousands of patent applications a year, although China has surpassed the United States in patent applications. This monopoly allows the developer to recover research, development, and production expenses and to earn a reasonable profit. A drug can receive a 17-year patent from the time it is discovered or the chemical is identified. For example, Tamiflu lost its patent, and now the generic version can be made by other firms.

Economic Cycles and Productivity

Expansion and Contraction. Economies are not stagnant; they expand and contract. **Economic expansion** occurs when an economy is growing and people are spending more money. Their purchases stimulate the production of goods and services, which in turn stimulates employment. The standard of living rises because more people are employed and have money to spend. Rapid expansions of the economy, however, may result in **inflation**, a continuing rise in prices. Inflation can be harmful if individuals' incomes do not increase at the same pace as rising prices, reducing their buying power. The worst case of hyperinflation occurred in Hungary in 1946. At one point, prices were doubling every 15.6 hours. One of the most recent cases of hyperinflation occurred in Zimbabwe. ¹² Zimbabwe suffered from hyperinflation so severe that its inflation percentage rate rose into the hundreds of millions. With the elimination of the Zimbabwean dollar and certain price controls, the inflation rate began to decrease, but not before the country's economy was virtually decimated. ¹³

Economic contraction occurs when spending declines. Businesses cut back on production and lay off workers, and the economy as a whole slows down. Contractions of the economy lead to **recession**—a decline in production, employment, and income. Recessions are often characterized by rising levels of **unemployment**, which is measured as the percentage of the population that wants to work but is unable to find jobs. Figure 1.3 shows the overall unemployment rate in the civilian labor force over the past 75 years. Rising unemployment levels tend to stifle demand for goods and services, which can have the effect of forcing prices downward, a condition known as *deflation*. Deflation poses a serious economic problem because price decreases could result in consumers delaying purchases. If consumers wait for lower prices, the economy could fall into a recession.

The United States has experienced numerous recessions, the most recent ones occurring in 1990–1991, 2002–2003, and 2008–2011. The most recent recession (or economic slowdown) was caused by the collapse in housing prices and consumers'

FIGURE 1.3 Annual Average Unemployment Rate, Civilian Labor Force, 16 Years and Over

Percentage Unemployed 16% 14 12 10 8 6 4 2 0 1950 1960 1980 2000 2008 2009 2010 2011 2012 2013 1940 1970 1990 2014 2015 Year

Sources: Bureau of Labor Statistics, "Labor Force Statistics from the Current Population Survey," http://data.bls.gov/timeseries/LNSI4000000 (acclessed March 25, 2018)

economic expansion

the situation that occurs when an economy is growing and people are spending more money; their purchases stimulate the production of goods and services, which in turn stimulates employment.

inflation

a condition characterized by a continuing rise in prices

economic contraction

a slowdown of the economy characterized by a decline in spending and during which businesses cut back on production and lay off workers.

recession

a decline in production, employment, and income.

unemployment

the condition in which a percentage of the population wants to work but is unable to find jobs.

depression

a condition of the economy in which unemployment is very high, consumer spending is low, and business output is sharply reduced.



Specify why and how the health of the economy is measured.

gross domestic product (GDP)

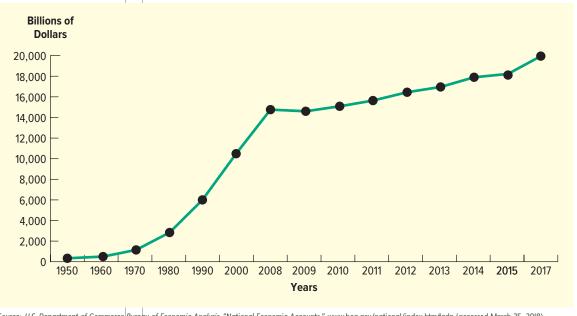
the sum of all goods and services produced in a country during a year.

FIGURE 1.4
Growth in U.S. Gross Domestic Product

inability to stay current on their mortgage and credit card payments. This caused a crisis in the banking industry, with the government bailing out banks to keep them from failing. This in turn caused a slowdown in spending on consumer goods and a decrease in employment. Unemployment reached 10 percent of the labor force. Don't forget that personal consumption makes up almost 70 percent of gross domestic product, so consumer engagement is extremely important for economic activity. A severe recession may turn into a depression, in which unemployment is very high, consumer spending is low, and business output is sharply reduced, such as what occurred in the United States in the early 1930s. The most recent recession is often called the Great Recession because it was the longest and most severe economic decline since the Great Depression.

Economies expand and contract in response to changes in consumer, business, and government spending. War also can affect an economy, sometimes stimulating it (as in the United States during World Wars I and II) and sometimes stifling it (as during the Vietnam, Persian Gulf, and Iraq wars). Although fluctuations in the economy are inevitable and to a certain extent predictable, their effects—inflation and unemployment—disrupt lives and thus governments try to minimize them.

Measuring the Economy. Countries measure the state of their economies to determine whether they are expanding or contracting and whether corrective action is necessary to minimize the fluctuations. One commonly used measure is **gross domestic product (GDP)**—the sum of all goods and services produced in a country during a year. GDP measures only those goods and services made within a country and therefore does not include profits from companies' overseas operations; it does include profits earned by foreign companies within the country being measured. However, it does not take into account the concept of GDP in relation to population (GDP per capita). Figure 1.4 shows the increase in U.S. GDP over several years, while Table 1.2 compares a number of economic statistics for a sampling of countries.



Source: U.S. Department of Commerce Bure au of Economic Analysis, "National Economic Accounts," www.bea.gov/national/index.htm#gdp.(accessed March 25, 2018).

TABLE 1.2
Economic Indicators of Different Countries

Country	GDP (in billions of dollars)	GDP per Capita	Unemployment Rate (%)	Inflation Rate (%)
Argentina	911	20,700	8.1	26.9
Australia	I,235	49,900	5.6	2.0
Brazil	3,219	15,500	13.1	3.7
Canada	1,764	48,100	6.5	1.6
China	23,120	16,600	4	1.8
France	2,826	43,600	9.5	1.2
Germany	4,150	50,200	3.8	1.6
India	9,447	7,200	8.8	3.8
Israel	315	36,200	4.3	0.2
Japan	5,405	42,700	2.9	0.4
Mexico	2,406	19,500	3.6	5.9
Russia	4,000	27,900	5.5	4.2
South Africa	757	13,400	27.6	5.4
United Kingdom	2,880	43,600	4.4	2.6
United States	19,360	59,500	4.4	2.1

Source: CIA, *The World Fact Book*, https://www.cia.gov/library/publications/the-world-factbook/rankorder/rankorderguide.html (accessed March 25, 2018).

Another important indicator of a nation's economic health is the relationship between its spending and income (from taxes). When a nation spends more than it takes in from taxes, it has a **budget deficit**. In the 1990s, the U.S. government eliminated its long-standing budget deficit by balancing the money spent for social, defense, and other programs with the amount of money taken in from taxes.

In recent years, however, the budget deficit has reemerged and grown to record levels, partly due to defense spending in the aftermath of the terrorist attacks of September 11, 2001. Massive government stimulus spending during the most recent recession also increased the national debt. Because many Americans do not want their taxes increased and Congress has difficulty agreeing on appropriate tax rates, it is difficult to increase taxes and reduce the deficit. Like consumers and businesses, when the government needs money, it borrows from the public, banks, and even foreign investors. The national debt is more than \$24 trillion. ¹⁴ This figure is especially worrisome because to reduce the debt to a manageable level, the government either has to increase its revenues (raise taxes) or reduce spending on social, defense, and legal programs, neither of which is politically popular. The United States recently enacted tax cuts that are projected to increase the national debt every year over the next 10 years. ¹⁵ The national debt figure changes daily and can be seen at the Department of the Treasury, Bureau of the Public Debt, website. Table 1.3 describes some of the other ways we evaluate our nation's economy.

budget deficit

the condition in which a nation spends more than it takes in from taxes.

TABLE 1.3

How Do We Evaluate Our Nation's Economy?



Outline the evolution of the American economy.

standard of living

refers to the level of wealth and material comfort that people have available to them.

open economy

an economy in which economic activities occur between the country and the international community.

Unit of Measure	Description
Trade balance	The difference between our exports and our imports. If the balance is negative, as it has been since the mid-1980s, it is called a trade deficit and is generally viewed as unhealthy for our economy.
Consumer Price Index	Measures changes in prices of goods and services purchased for consumption by typical urban households.
Per capita income	Indicates the income level of "average" Americans. Useful in determining how much "average" consumers spend and how much money Americans are earning.
Unemployment rate	Indicates how many working-age Americans are not working who otherwise want to work.
Inflation	Monitors price increases in consumer goods and services over specified periods of time. Used to determine if costs of goods and services are exceeding worker compensation over time.
Worker productivity	The amount of goods and services produced for each hour worked.

The American Economy

As we said previously, the United States is a mixed economy with a foundation based on capitalism. The answers to the three basic economic issues are determined primarily by competition and the forces of supply and demand, although the federal government does intervene in economic decisions to a certain extent. For instance, the federal government exerts oversight over the airline industry to make sure airlines remain economically viable as well as for safety and security purposes.

Standard of living refers to the level of wealth and material comfort that people have available to them. The United States, Germany, Australia, and Norway all have a high standard of living, meaning that most of their citizens are able to afford basic necessities and some degree of comfort. These nations are often characterized by a high GDP per capita. However, a higher GDP per capita does not automatically translate into a higher standard of living. Costs of goods and services are also factors. The European Union and Japan, for instance, tend to have higher costs of living than in the United States. Higher prices mean that it costs more to obtain a certain level of comfort than it does in other countries. Countries with low standards of living are usually characterized by poverty, higher unemployment, and lower education rates. To understand the current state of the American economy and its effect on business practices, it is helpful to examine its history and the roles of the entrepreneur and the government.

The Importance of the American Economy

The American economy is an **open economy**, or an economy in which economic activities occur between the country and the international community. As an open economy, the United States is a major player in international trade. Open economies tend to grow faster than economies that do not engage in international trade. This is because international trade is positively related to efficiency and productivity. Companies in the United States have greater access to a wider range of resources and knowledge, including technology. In today's global environment, the ability to harness technology is critical toward increased innovation. ¹⁶ In contrast, research

indicates a negative relationship between regulatory actions and innovation in firms, suggesting that too much regulation hinders business activities and their contribution to the American economy.¹⁷

When looking at the American economy, growth in GDP and jobs are the two primary factors economists consider. A positive relationship exists between a country's employment rate and economic growth. A nation's output depends on the amount of labor used in the production process, so there is also a positive correlation between output and employment. In general, as the labor force and productivity increase, so does GDP. Profitable companies tend to hire more workers than those that are unprofitable. Therefore, companies that hire employees not only improve their profitability but also drive the economic well-being of the American economy.¹⁸

Government public policy also drives the economy through job creation. In order for any nation to ensure the social and economic health of the country, there must be a tax base to provide for the public interest. The vast majority of taxes come from individuals. It is estimated that the U.S. government obtains \$2.3 trillion in individual income taxes annually. Figure 1.5 shows the distribution of returns and income taxes paid by individuals based on their gross income. Unmarried individuals who earn more than \$500,000 pay 37 percent of individual income taxes.

Businesses are also an important form of tax revenue. Those that are classified as sole proprietorships, partnerships, and S corporations (discussed further in the chapter titled "Options for Organizing Business") pay taxes according to the individual income tax code. Corporations are taxed differently. Approximately 10.6 percent of the government's total revenues comes from corporate income taxes. ²¹ In 2017, the largest tax reform in the U.S. tax rate in over 30 years changed the corporate tax rate from 35 percent to 21 percent. ²² The average global corporate tax rate is 23 percent, while some countries such as Ireland have a corporate tax rate as low as 12.5 percent. The tax reform lowered the highest individual tax rate from 39.6 percent to 37 percent, but the reform capped the deduction of state and local taxes at \$10,000. This could result in high-earners in states like New York and California with state and local taxes paying more federal taxes than before the tax reform. ²³ The tax reform was designed to stimulate the economy but will increase the national debt.

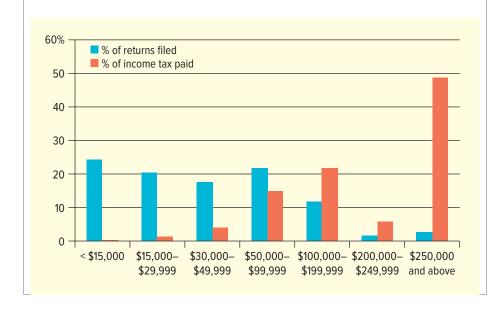


FIGURE 1.5 Individual Income Tax Statistics by Income Group

Source: Internal Revenue Service, Individual Income Tax Rates and Tax Shares, (accessed March 25, 2018).



Responding to Business Challenges

The Trix of the Trade: General Mills' Brand Strategy

In its 150-year history, General Mills has evolved from a flour mill to a packaged consumer goods company with revenues of \$16 billion. More recently, General Mills has begun investing heavily in organic and natural foods with its acquisition of organic food brands Cascade Farms and Annie's. Sales of organic products are a \$43.4 billion industry and growing. Demand for organic food is growing so rapidly that the supply has been unable to keep up. As a result, General Mills has begun underwriting the costs for farmers to convert their farms to organic crops.

The consumer goods market is characterized by monopolistic competition, meaning that General Mills has many competitors. This requires General Mills to adapt to changing consumer preferences. For example, consumers have been eating less cereal and looking for quick breakfast items like yogurt and breakfast bars. As a result, General Mills has expanded into more on-the-go products such as yogurt and granola. Perhaps as a way to meet the competition head on, General Mills has adopted a new brand strategy: "Consumers first."

General Mills wants its customer-centric focus to differentiate it from rival firms. In keeping with this customer emphasis, it has agreed to adopt genetically modified organism (GMO) labeling for some of its products. While General Mills believes GMO products are safe, it wants customers to know that it is listening to their concerns. In fact, General Mills became a first mover in this endeavor by reformulating its Cheerios to be GMO-free. However, as competitors also turn toward organic ingredients, it might not be long before other cereal manufacturers begin developing their own GMO-free cereals. General Mills must continue to innovate to maintain its competitive edge.²⁴

Critical Thinking Questions

- I. Why does the consumer goods industry operate in an environment of monopolistic competition? What must firms like General Mills do to succeed in this environment?
- 2. How is General Mills addressing the supply-demand problem that it is facing with organic food?
- 3. What are some of the ways in which General Mills is differentiating its products from the competition?

A Brief History of the American Economy

The Early Economy. Before the colonization of North America, Native Americans lived as hunter/gatherers and farmers, with some trade among tribes. The colonists who came later operated primarily as an *agricultural economy*. People were self-sufficient and produced everything they needed at home, including food, clothing, and furniture. Abundant natural resources and a moderate climate nourished industries such as farming, fishing, shipping, and fur trading. A few manufactured goods and money for the colonies' burgeoning industries came from England and other countries.

As the nation expanded slowly toward the West, people found natural resources such as coal, copper, and iron ore and used them to produce goods such as horseshoes, farm implements, and kitchen utensils. Farm families who produced surplus goods sold or traded them for things they could not produce themselves, such as fine furniture and window glass. Some families also spent time turning raw materials into clothes and household goods. Because these goods were produced at home, this system was called the domestic system.

The Industrial Revolution. The 19th century and the Industrial Revolution brought the development of new technology and factories. The factory brought together all the resources needed to make a product—materials, machines, and workers. Work in factories became specialized as workers focused on one or two tasks. As work became more efficient, productivity increased, making more goods available at lower prices. Railroads brought major changes, allowing farmers to send their surplus crops and goods all over the nation for barter or for sale.

Factories began to spring up along the railways to manufacture farm equipment and a variety of other goods to be shipped by rail. Samuel Slater set up the first American textile factory after he memorized the plans for an English factory and emigrated to the United States. Eli Whitney revolutionized the cotton industry with his cotton gin. Francis Cabot Lowell's factory organized all the steps in manufacturing cotton cloth for maximum efficiency and productivity. John Deere's farm equipment increased farm production and reduced the number of farmers required to feed the young nation. Farmers began to move to cities to find jobs in factories and a higher standard of living. Henry Ford developed the assembly-line system to produce automobiles. Workers focused on one part of an automobile and then pushed it to the next stage until it rolled off the assembly line as a finished automobile. Ford's assembly line could manufacture many automobiles efficiently, and the price of his cars was \$200, making them affordable to many Americans.

The Manufacturing and Marketing Economies. Industrialization brought increased prosperity, and the United States gradually became a manufacturing economy—one devoted to manufacturing goods and providing services rather than producing agricultural products. The assembly line was applied to more industries, increasing the variety of goods available to the consumer. Businesses became more concerned with the needs of the consumer and entered the *marketing economy*. Expensive goods such as cars and appliances could be purchased on a time-payment plan. Companies conducted research to find out what products consumers needed and wanted. Advertising made consumers aware of products and important information about features, prices, and other competitive advantages.

Because these developments occurred in a free-enterprise system, consumers determined what goods and services were produced. They did this by purchasing the products they liked at prices they were willing to pay. The United States prospered, and American citizens had one of the highest standards of living in the world.

The Service and New Digital Economy. After World War II, with the increased standard of living, Americans had more money and more time. They began to pay others to perform services that made their lives easier. Beginning in the 1960s, more and more women entered the workforce. The United States began experiencing major shifts in the population. The U.S. population grew about 10 percent in the past decade to 327 million. This is the slowest pace of growth since the Great Depression, with the South leading the population gains. The United States is undergoing a baby bust, with record lows in the country's fertility rate. 25 While the birth rate in the United States is declining, new immigrants help with population gains.²⁶ The profile of the family is also changing: Today there are more single-parent families and individuals living alone, and in two-parent families, both parents often work.

One result of this trend is that time-pressed Americans are increasingly paying others to do tasks they used to do at home, like cooking, laundry, landscaping, and child care. These trends have gradually changed the United States to a service economy—one devoted to the DID YOU KNOW? Approximately 57 percent of adult production of services that make life easier for busy con- women are involved in the workforce.²⁷ sumers. Businesses increased their demand for services,

especially in the areas of finance and information technology. Service industries such as restaurants, banking, health care, child care, auto repair, leisure-related industries, and even education are growing rapidly and may account for as much as 80 percent of the U.S. economy. These trends continue with advanced technology contributing to

FIGURE 1.6 Online Retailing and E-Commerce

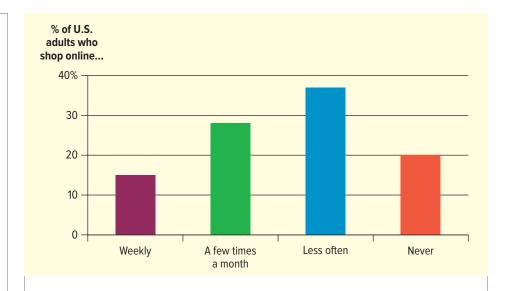
Source: Aaron Smith and Monica Anderson, "Online Shopping and E-Commerce," Pew Research Center, December 19, 2016, http://www pewinternet.org/2016/12/19/onlineshopping-and-e-commerce/ (accessed March 25, 2018).

LO 1-8

Explain the role of the entrepreneur in the economy.

entrepreneur

an individual who risks his or her wealth, time, and effort to develop for profit an innovative product or way of doing something.



new service products based on technology and digital media that provide smartphones, social networking, and virtual worlds. This has led to the growth of e-commerce, or transactions involving goods and services over the Internet. E-commerce has led to firms that would have been unheard of a few decades ago, such as eBay, Shopify, Etsy, and Amazon. Figure 1.6 shows the percentage of adults who engage in e-commerce. More about the digital world, business, and new online social media can be found in the chapter titled "Digital Marketing and Social Networking."

The Role of the Entrepreneur

An **entrepreneur** is an individual who risks his or her wealth, time, and effort to develop for profit an innovative product or way of doing something. Heidi Ganahl is a true American entrepreneur. She took the unusual concept of a day care center for dogs and turned it into a successful \$85 million franchise operation. Her business, Camp Bow Wow, which offers boarding, playtime, grooming, and other services for dogs, expanded to more than 140 locations and plans to grow to 1,000 over the next several years.²⁸

The free-enterprise system provides the conditions necessary for entrepreneurs like Ganahl to succeed. In the past, entrepreneurs were often inventors who brought all the factors of production together to produce a new product. Thomas Edison, whose inventions include the record player and light bulb, was an early American entrepreneur. Henry Ford was one of the first persons to develop mass assembly methods in the automobile industry. Other entrepreneurs, so-called captains of industry, invested in the country's growth. John D. Rockefeller built Standard Oil out of the fledgling oil industry, and Andrew Carnegie invested in railroads and founded the United States Steel Corporation. Andrew Mellon built the Aluminum Company of America and Gulf Oil. J. P. Morgan started financial institutions to fund the business activities of other entrepreneurs. Although these entrepreneurs were born in another century, their legacy to the American economy lives on in the companies they started, many of which still operate today. Consider the history of Eli Lilly. Colonel Eli Lilly in Indianapolis, Indiana, was continually frustrated with the quality of pharmaceutical products sold at the time. As a pharmaceutical chemist, he decided to start his own



Entrepreneurship in Action

ATA: Engineering Good Teamwork

ATA Engineering

Founder: Mary Baker

Founded: 2000, in San Diego, CA

Success: This 100 percent employee-owned firm has won numerous awards, including a quality award from NASA and a spot among *The Wall Street Journal's* Top Small Workplaces.

ATA Engineering is a unique firm because—although founder Mary Baker plays a role in the company as president and director—the company became entirely employee owned a mere four years after its founding. This gives the I20 employees at ATA Engineering greater motivation to make it profitable because they succeed when the company succeeds.

ATA Engineering Inc. is a provider of analysis and testdriven design solutions for structural, mechanical, electromechanical, and aerospace products. When it was founded, ATA Engineering was not the only engineering firm in the industry. Competition was high. However, it was spun off from Structural Dynamics Research Corporation, a firm that had worked on NASA projects. As a spinoff, ATA Engineering had the expertise needed to continue this relationship. The company gained a competitive advantage with its role as a NASA contractor. More recently, the firm has helped to solve design issues on NASA's Mars Science Lab, which earned it the George M. Low Award, NASA's quality and performance award. Today, ATA Engineering operates in seven offices across the nation.²⁹

Critical Thinking Questions

- I. How does creating an employee-owned business give employees greater motivation to make the business profitable?
- 2. What are the disadvantages of an employee-owned business?
- 3. In what other ways does ATA stand apart from its competitors?

firm that would offer the highest-quality medicines. His firm, Eli Lilly and Company, would go on to make landmark achievements, including being one of the first pharmaceutical firms to mass-produce penicillin. Today, Eli Lilly is one of the largest pharmaceutical firms in the world.³⁰

Entrepreneurs are constantly changing American business practices with new technology and innovative management techniques. Bill Gates, for example, built Microsoft, a software company whose products include Word and Windows, into a multibillion-dollar enterprise. Frederick Smith had an idea to deliver packages overnight, and now his FedEx Company plays an important role in getting docu-

ments and packages delivered all over the world for businesses and individuals. Steve Jobs co-founded Apple and turned the company into a successful consumer electronics firm that revolutionized many different industries, with products such as the iPod, iPhone, Mac computers, iPad, and Apple Watch. The company went from near bankruptcy in the 1990s to become one of the most valuable brands in the entire world. Entrepreneurs have been associated with such uniquely American concepts as Dell Computers, Ben & Jerry's, Levi's, McDonald's, Dr Pepper, SpaceX, Google, Facebook, and Walmart. Walmart, founded by entrepreneur Sam Walton, was the first retailer to reach \$100 billion in sales in one year and now routinely passes that mark, with more than \$453 billion in 2017.³¹ We will examine the importance of entrepreneurship further in the chapter "Small Business, Entrepreneurship, and Franchising."



Apple Pay is a mobile payment system that allows users to store credit card or debit card information on their phones. When checking out at stores, users can bring up their credit card with two taps and use the information to pay for their purchases.

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Going Green

Rainforest Alliance Stands Out in a Forest of Nonprofits

When you think of the phrase "nonprofit organization," you likely think of a bare-bones operation run by people who are so dedicated that they do not mind working for peanuts. However, the Rainforest Alliance, a highly recognized nonprofit aiming to conserve biodiversity and promote sustainability, defies this mold. With thousands of members and supporters, the Rainforest Alliance has been fighting globally for wildlife and wild lands since 1987.

As more consumers and businesses become interested in preserving the world's resources, the Rainforest Alliance has gained widespread support. Interacting with key stakeholders is critical to the Rainforest Alliance's success. For instance, the Rainforest Alliance has many resources for businesses that partner with the organization. The Rainforest Alliance provides auditing and certification services for businesses—such as agricultural, tourism, and forestry organizations—that wish to display the Rainforest Alliance blog describes how sustainability can positively affect a business, and its seal is one way businesses can inform

consumers that they have incorporated sustainability principles into their operations. The Rainforest Alliance even has its own business unit, called RA-Cert, involved with auditing, evaluation, and certification decisions. Additionally, the Rainforest Alliance offers resources to businesses that want to educate their own employees about sustainability.

Stakeholders generally have a positive image of the Rainforest Alliance. One survey noted that coffee drinkers were likely to spend extra on coffee certified by Rainforest Alliance. For individuals looking to aid the environment and support small growers, the Rainforest Alliance is making a positive difference with its strong mission and interaction with stakeholders.³²

Critical Thinking Questions

- I. Why might investing in sustainability and becoming certified by an organization like the Rainforest Alliance be a good business decision?
- 2. Who do you feel are Rainforest Alliance's primary customers: consumers or businesses?
- 3. As a nonprofit, how does the Rainforest Alliance differ from other organizations?

The Role of Government in the American Economy

The American economic system is best described as modified capitalism because the government regulates business to preserve competition and protect consumers and employees. Federal, state, and local governments intervene in the economy with laws and regulations designed to promote competition and to protect consumers, employees, and the environment. Many of these laws are discussed in Bonus Chapter A.

Additionally, government agencies such as the U.S. Department of Commerce measure the health of the economy (GDP, productivity, etc.) and, when necessary, take steps to minimize the disruptive effects of economic fluctuations and reduce unemployment. When the economy is contracting and unemployment is rising, the federal government through the Federal Reserve Board (see chapter titled "Money and the Financial System") tries to spur growth so that consumers will spend more money and businesses will hire more employees. To accomplish this, it may reduce interest rates or increase its own spending for goods and services. When the economy expands so fast that inflation results, the government may intervene to reduce inflation by slowing down economic growth. This can be accomplished by raising interest rates to discourage spending by businesses and consumers. Techniques used to control the economy are discussed in "Money and the Financial System."

The Role of Ethics and Social Responsibility in Business

In the past few years, you may have read about a number of scandals at well-known corporations, including Volkswagen, which cheated on emissions tests, and Wells Fargo. Wells Fargo employees opened more than 3.5 million accounts in customer