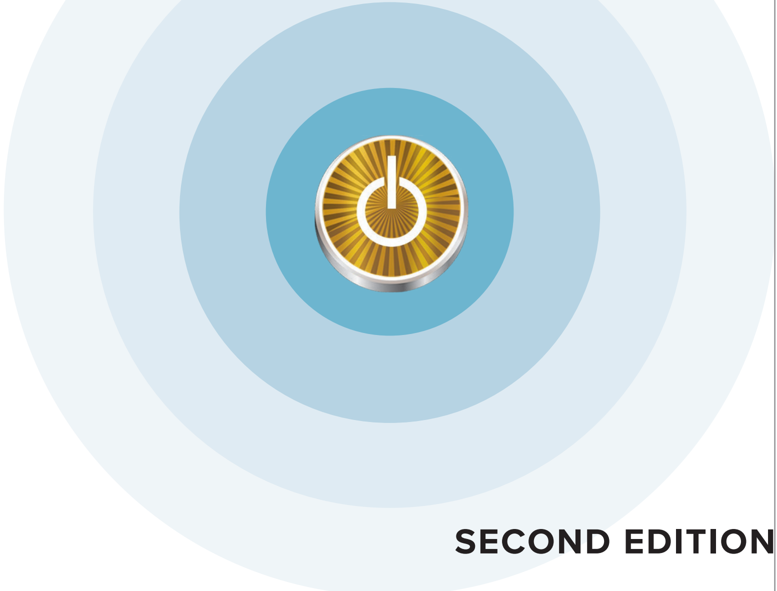
UNDERSTANDING Business

The Core



SECOND EDITION

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UNDERSTANDING Business

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SECOND EDITION

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APPLIED LEARNING SYSTEMS

Mc Graw Hill

UNDERSTANDING BUSINESS: THE CORE, SECOND EDITION

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DEDICATION

To our families—Marsha, Joel, Carrie, Claire, Casey, Dan, Molly, Michael, Lindsay, Patrick, and Quinn. Thank you for making everything worth doing and giving us the support to do it well!

AND

To the team that made this edition possible, especially the instructors and students who gave us such valuable guidance as we developed the text and package.

ABOUT THE AUTHORS

Bill Nickels is emeritus professor of business at the University of Maryland, College Park. He has over 30 years' experience teaching graduate and undergraduate business courses, including introduction to business, marketing, and promotion. He has won the Outstanding Teacher on Campus Award four times and was nominated for the award many other times. He received his MBA degree from Western Reserve University and his PhD from Ohio State University. Bill has written a marketing communications text and two marketing principles texts in addition to many articles in business publications. He has taught many seminars to businesspeople on subjects such as power communications, marketing, nonbusiness marketing, and stress and life management. His son, Joel, is a professor of English at the University of Miami (Florida).

Jim McHugh holds an MBA degree from Lindenwood University and has had broad experience in education, business, and government. As chair of the Business and Economics Department of St. Louis Community College–Forest Park, Jim coordinated and directed the development of the business curriculum. In addition to teaching several sections of Introduction to Business each semester for nearly 30 years, Jim taught in the marketing and management areas at both the undergraduate and graduate levels. Jim enjoys conducting business seminars and consulting with small and large businesses. He is actively involved in the public-service sector and served as chief of staff to the St. Louis County Executive.

Susan McHugh is a learning specialist with extensive training and experience in adult learning and curriculum development. She holds an MEd degree from the University of Missouri and completed her course work for a PhD in education administration with a specialty in adult learning theory. As a professional curriculum developer, she has directed numerous curriculum projects and educator training programs. She has worked in the public and private sectors as a consultant in training and employee development. While Jim and Susan treasure their participation in writing projects, their greatest accomplishment is their collaboration on their three children. Casey is carrying on the family's teaching tradition as an adjunct social work professor at Washington University and the founder of an incubator to help therapists start their own practices. Molly and Michael are carrying on the family writing tradition by contributing to the development of this text and several supplementary materials.

THE **GOLD** ★★★★ STANDARD

Preparing Future-Ready Learners

Congratulations. You've made an excellent selection. Welcome to the preeminent teaching and learning experience ever created for Introduction to Business classes.

Our experienced and diverse authors and long-tenured editorial team have created a product that meets the needs of nearly all classrooms, no matter the size, teaching modality, or learning objectives. The content is unmatched in depth, breadth, currency, and relevancy, and is presented in an extremely readable format for students with all learning styles. A wealth of technology solutions engages students, enriches learning, furthers understanding, and simplifies instructors' assessment processes. Course supplements tightly align with chapter concepts and enhance retention, making instructors of all experience levels Grade-A rock stars. Unparalleled support from our digital faculty consultants helps ensure you and your students benefit from the full experience of what is now the gold standard in Introduction to Business classes. Nickels/McHugh/McHugh, *Understanding Business: The Core,* 2e does more than teach—it prepares students to create real impact on the world.

1. The Gold Standard in Relevancy and Currency

Real-world case studies—across nearly all industries and company sizes—ensure your students are apprised of the most current challenges businesspeople face today. From Brexit and ransomware to 3D printing and robo-advisors, you have access to numerous relevant samples that tie directly into chapter lessons. Plus with the option to take advantage of the ***From the News to the Classroom*** **blog,** you can enrich the learning experience with content that is updated multiple times each week and includes abstracts of relevant news stories, videos tied to chapter topics, and critical thinking questions that streamline your prep time and help create an ultra-current course.

2. The Gold Standard in Results-Driven Technology

Interactive learning tools increase teaching effectiveness and learning efficiency by facilitating a stronger connection between the course material and the modern student.

Where the Science of Learning Meets the Art of Teaching *McGraw-Hill Connect* is the leading online assignment and assessment solution that connects students with the tools and resources they need to achieve success. It also allows instructors to quickly and easily choose the content and assignments that will best emphasize the learning objectives they prefer to cover. The result is a customized course, rich with engaging presentations and activities that prepare students for the business world.

The First and Only Adaptive Reading Experience *SmartBook 2.0* creates a dynamic reading experience and personalizes content for each student, helping students master and retain foundational concepts. Tracking each student's progress, it automatically assesses comprehension levels and delivers the content required to reinforce topics needing more attention. This continuously adaptive learning path is proven to accelerate learning and strengthen memory recall, all while providing instructors a turnkey tool that ensures students stay on track.

Bridging the Gap between Concept and Application Having knowledge is the first step—and understanding how to apply that knowledge is what determines a person's success in the business world. That's why we provide an array of application exercises that are as educational as they are engaging. *Click-and-Drag* exercises reinforce key models and processes. *Video Cases* allow students to observe and analyze key concepts as they are utilized by companies and organizations they know and recognize. Case analyses expose students to real-world scenarios and engage their critical-thinking and analysis skills. New to this edition, 15-minute *Mini-Simulations* put students in the role of business professionals, allowing them to make decisions and learn from the results. Also new to this edition, *Auto-Scored Writing Assignments* evaluate, score and gives feedback on student responses to short answer prompts.

3. The Gold Standard in Teaching Resources

Whether it's your first or fortieth year teaching, you can benefit from a wealth of assessments and class-tested resources that simplify your evaluation process and enrich the learning experience.

Assessment Tools:

- **NEW SmartBook 2.0** personalizes learning to individual student needs, continually adapting to pinpoint knowledge gaps and focus learning on topics that need the most attention. With SmartBook 2.0, learning is more productive and takes the guess work out of what to study in a no-fail environment. The result, students are better prepared for class and coursework.
- **NEW Auto Scored Writing Assignments** evaluates, scores and gives feedback on student responses to provided prompts.
- **NEW Mini-Simulations** are highly interactive, automatically graded exercises that immerse students in a business environment, analyze the situation, and apply their knowledge to a real-world scenario.
- **Business Plan Prep Assignments** guide students in creating a basic business plan.
- **Test Bank** that is the largest and most accurate collection of questions on the market, including over 300 questions per chapter, making testing student knowledge a simple and efficient process.

Higher Order Thinking Skills ↑ / Lower Order Thinking Skills ↓

	SmartBook® 2.0	ISee it! Videos	Video Cases/ Analytics	Click and Drag	Hot Seat Videos	Mini Simulations	Business Plan Prep	Auto-Scored Writing Assignments
CREATE							✓	✓
EVALUATE						✓	✓	✓
ANALYZE					✓	✓	✓	✓
APPLY			✓	✓	✓	✓	✓	✓
UNDERSTAND	✓	✓	✓	✓	✓	✓	✓	✓
REMEMBER	✓	✓	✓	✓	✓	✓	✓	✓

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- **Chapter Interactive Assignments** challenge students to demonstrate their knowledge of key concepts and terms by applying them to a variety of business-world scenarios.
- **Video assignments** help explain difficult concepts and show business concepts in action.

Additional Resources:

- **Teacher's resource manual** includes tools to improve retention and engagement, while helping save the instructor's time.
- ***From the News to the Classroom* blog** is updated multiple times each week, featuring abstracts of relevant news stories, video tied to chapter topics, and critical-thinking questions that streamline your prep time and help create an ultra-current course.
- **PowerPoint presentations** include integrated polling questions that improve student engagement.
- **Video library** with Video Teaching Guide includes:
  - **Company case videos** produced specifically to expound on chapter learning objectives via real-world business situations across a broad range of industries, sizes, and geographic locations, allowing students to contextualize the chapter's content.
  - **Hotseat videos** offer short cases that show real business professionals confronting a variety of workplace challenges.
  - **iSeeIt! animated video explanations** clarify some of the most important topics and can be accessed within the e-book.
  - **Current video clips** on the *From the News to the Classroom* blog tie to chapter topics and keep your classroom current.

4. The Gold Standard in Support, Service, and Solutions

We want you to get the most out of our products, and we do everything possible to help provide your students an exceptional learning experience. From the first to the last day of the semester, we support you with:

- Learning technology representatives
- Digital faculty consultants
- Student ambassadors
- Implementation consultants
- Technical support
- Integration with your learning management system
- Content your way/customizable content/a robust library of cross-disciplinary content
- Student progress-tracking
- Accreditation and assurance of learning ready

Our team of digital faculty consultants and extensive toolbox of support programs ensure you receive the full value of all this product has to offer.

The Bottom Line

The business world is constantly changing, and your classroom needs to keep up. With Nickels/McHugh/McHugh, *Understanding Business: The Core*, 2nd Edition, both you and your students can experience *the Gold Standard* in Introduction to Business classes.

Changes to the New Edition

Fewer Chapters! You asked for it—you got it. Many reviewers asked us to reduce the number of chapters in the text and to include a chapter on using technology (particularly social media). *Understanding Business: The Core 2e* is now a trim 16 chapters. Here's how we did it:

- Chapter 1 (Taking Risks and Making Profits within the Dynamic Business Environment) and Chapter 2 (Understanding Economics) were condensed and combined to create **Chapter 1 Exploring the Business Environment and Economics.** Note: The coverage of current trends was deleted since it is covered in other chapters.
- Chapter 11 (Human Resource Management: Finding and Keeping the Best Employees and Chapter 12 (Dealing with Employee–Management Issues) were condensed and combined to create **Chapter 10 Human Resource Management: Finding and Keeping the Best Employees.**
- Chapter 16 (Financial Management) was combined with Chapter 17 (Using Securities Markets for Financing and Investing Opportunities) to create **Chapter 15 Financial Management.** Note: This revised chapter retains the material about selling stocks and bonds to raise capital. The content about investing in stocks and bonds was moved to Bonus Chapter C Managing Personal Finances and Investing.
- Bonus Chapter B (Using Technology to Manage Business) was expanded and promoted to the main text as **Chapter 13 Using Technology to Manage Information.**
- **Bonus Chapter C Managing Personal Finance and Investing** was expanded to include a condensed version of the content regarding investing in stocks and bonds that was moved from the former Securities Markets chapter.

New! You also asked us to include more information about careers in business. We added a section to the end-of-chapter material, **Career Exploration,** which identifies potential career opportunities.

Current! Users of *Understanding Business* have always appreciated the currency of the material and the large number of examples from companies of all sizes and industries (e.g., service, manufacturing, nonprofit, and profit) in the United States and around the world. Accordingly, the latest business practices and other developments affecting business include:

- Brexit
- Gig economy
- Social media advertising
- Social networking
- Benefit corporations
- Circular economy
- Products as services
- Human resource information systems (HRISs)
- Market-based pay structure
- On-call scheduling
- Continuous performance reviews
- Bullying in the workplace
- Ban-the-box job application and initial interview rule
- Holocracy
- Drones

- 3D printing and additive manufacturing
- Wells Fargo and Volkswagen scandals
- 2016 Supreme Court decision on insider trading
- Robo-advisors
- Ransomware
- And much, much more

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Many dedicated educators and content experts made extraordinary contributions to the quality and utility of this teaching and learning package. For this edition, Diana Murphy and her team at Editors Inc. did a superb job of creating a useful and current Teacher's Resource Manual. Molly McHugh updated the Test Bank and contributed to the revised Teacher's Resource Manual. We also recognize the efforts of Stacy Martin at Southwestern Illinois College, who contributed to the creation of Connect materials. We are grateful to our SmartBook team: in particular to Judy Bulin at Monroe Community College, who tirelessly worked to review and perfect the probes and feedback and respond to student queries, along with Mary Ewanechko, John Striebich, and Kathleen Borbee. Thank you to Kelly Luchtman and her team at Lightfellow for the fabulous new videos they produced. Thank you to the Digital Faculty Consultants who have helped train and support so many of their fellow instructors in the Introduction to Business course, as well as assist them in successfully implementing Connect into their courses: Cathleen Cogdill, *Northern Virginia Community College;* Chris Finnin, *Drexel University;* Stacy Martin, *Southwestern Illinois College;* Allison McGullion, *KCTCS West Kentucky Community and Tech College;* Tim Rogers, *Ozarks Technical Community College;* Steven Sedky, *Santa Monica College;* and Gail Zwart, *Riverside City College.* We would like to give special thanks to Tim Rogers for his dedication to this project including the hard work he did revising the student study guide.

Our outstanding marketing manager, Gabe Fedota, and marketing director, Robin Lucas, were up to the challenge of guiding the text to continued market leadership. With the assistance of the market's finest sales professionals, they led to the success of the inaugural edition of *The Core.* We want to thank the many instructors who contributed to the development of *Understanding Business: The Core 2e.*

Reviewers

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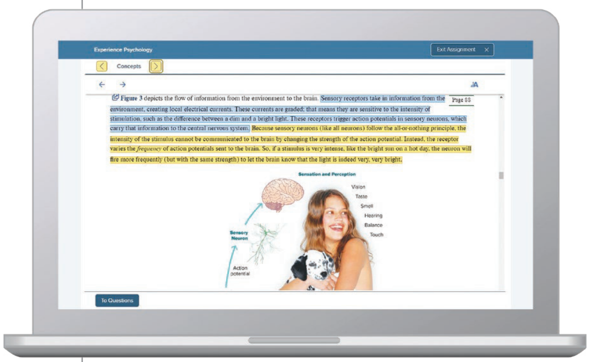

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BRIEF CONTENTS

CONTENTS

Rev. Confirming Pages

BONUS CHAPTERS

A
Working within the Legal Environment

B
Managing Risk

C
Managing Personal Finances and Investing

EPILOGUE
Getting the Job You Want

UNDERSTANDING
Business
The Core

SECOND EDITION

Part 1 **Business Trends:** Cultivating a Business in Diverse, Global Environments

1

Exploring the Business Environment and Economics

LEARNING OBJECTIVES

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

LO 1–1 Describe the relationship between profit and risk, and show how businesses and nonprofit organizations can raise the standard of living for all.

LO 1–2 Describe how each of the five elements of the business environment affect business.

LO 1–3 Explain basic economics.

LO 1–4 Compare and contrast the various types of economic systems and explain the trend toward mixed economies.

LO 1–5 Describe the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.

LO 1–6 Contrast fiscal policy and monetary policy, and explain how each affects the economy.

LO 1–7 Review how past trends are being repeated in the present and what those trends mean for tomorrow's college graduates.

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GETTING TO KNOW

Ann-Marie Campbell of Home Depot

Starting a new job isn't easy. With many things to learn and people to meet, even experienced workers can get overwhelmed on their first day at work on a new job. So imagine how Ann-Marie Campbell must have felt more than 30 years ago, when as a new immigrant with a thick Jamaican accent, she walked into Home Depot for her first shift. But thanks to her hard work and committed attitude, Campbell rose up the ranks at Home Depot. Now as executive vice president of U.S. stores, she oversees the operation of more than 2,000 locations.

Campbell was born in the Jamaican capital of Kingston to a successful couple with four children. But this happy childhood took a tragic turn when her father died in a car accident. Campbell and her siblings spent the rest of their youth being raised mainly by their grandmother, an intensely driven woman with no fear of hard work. "My grandmother was divorced and she had 10 children herself," said Campbell. "She started selling lace on the side of the road and then grew that into a multimillion-dollar business—a retail store selling mostly furniture and appliances."

This store became Campbell's second home when she had time off from the strict boarding school she attended. Helping her grandmother with day-to-day duties taught her many important lessons about how to do business. Her grandmother's advice and the discipline she learned at school helped Campbell enormously when she made the move to Miami as a teenager and got a job as a part-time sales associate at Home Depot to help pay her college tuition. While Campbell's experience and dedication helped her excel at the job quickly, she still faced a number of challenges in this new environment. "I was really the only woman on the sales floor back then, and when customers would come in with an issue, they'd demand to speak to, you know, a guy," said Campbell. Rather than lose her temper, though, she developed a clever response to this demand. "I'd pick the guy who knew the least to come help. The man would always have to kick the question back to me."

A similarly bold move brought Campbell to the attention of Home Depot's upper management. One day, a company executive visited the store and asked a big group of employees a question. None of her co-workers responded, but Campbell confidently answered the executive's inquiry. "Later, when he was walking out of the store, he asked the manager who I was," said Campbell. "That's how I got on the radar." This boost gave her the confidence and the connections to pursue promotions within the company. Her first advanced post was as head of the paint department, followed eventually by her appointment as manager of the entire store.

Campbell earned a master of business administration in 2005 that allowed her to climb even higher up the corporate ladder. By 2016 she became executive vice president of U.S. stores, a position that places her in charge of Home Depot's more than 400,000 employees. Every day Campbell works to provide these employees with the same opportunities for advancement that she received, which is a duty she does not take lightly. "It's only when you develop others that you permanently succeed," said Campbell. "When I do have opportunities to speak to students, or even to my kids, that's the type of value that I instill in them. It's not just about you. The world is a community. Everyone has their part, so let's go out and make sure everyone is able to do it successfully." Campbell's efforts have not gone unrecognized. *Fortune* magazine listed her among its top 50 most powerful women in business for four consecutive years. DoSomething.org named her one of its 2018 Inspirational 25, a group of leaders who are shattering expectations and challenging the status quo in the pursuit of a better world.

The business environment is constantly changing, and along with those changes come opportunities. The purpose of this chapter, and this textbook, is to introduce you to the dynamic world of business and to some of the people who thrive in it. Businesspeople like Ann-Marie Campbell contribute much to the communities they serve, and they also make a good living doing so. That's what business is all about.

Sources: Doug Gillett, "Ann-Marie Campbell's American Dream," *Georgia State University Magazine*, accessed March 2019; Ellen McGirt, "How Home Depot's Ann-Marie Campbell Rose from Cashier to the C-Suite," *Fortune*, September 13, 2016; "Ann-Marie Campbell's American Dream," Funvibes Radio, February 18, 2016; Henry Unger, "'If You Have a Seat at the Table, Speak Up,'" *Atlanta Journal Constitution*, March 26, 2015; Boardroom Insiders, "Ann-Marie Campbell," accessed March 2019; Daphne Howland, "Women in Retail among Fortune's 'Most Powerful,'" retaildive.com, September 25, 2018; "Most Powerful Women in Business," fortune.com, September 23, 2019; homedepot.com, accessed October 2019.

Melissa Golden/Redux

EVEN THOUGH THIS IS A JAPANESE COMPANY, the production values from its factory in Ohio are included in the U.S. GDP. Name that company. (You will find the answer in this chapter.)

LO 1–1 **Describe the relationship between profit and risk, and show how businesses and nonprofit organizations can raise the standard of living for all.**

business
Any activity that seeks to provide goods and services to others while operating at a profit.

goods
Tangible products such as computers, food, clothing, cars, and appliances.

services
Intangible products (i.e., products that can't be held in your hand) such as education, health care, insurance, recreation, and travel and tourism.

revenue
The total amount of money a business takes in during a given period by selling goods and services.

Business and Wealth Building

Success in business is based on constantly adapting to changes in the market. A **business** is any activity that seeks to provide goods and services to others while operating at a profit. **Goods** are *tangible* products such as computers, food, clothing, cars, and appliances. **Services** are *intangible* products (i.e., products that can't be held in your hand) such as education, health care, insurance, recreation, and travel and tourism. Once you have developed the right goods and services, based on consumer wants and needs, you need to reach those consumers using whatever media they prefer, including TV, social media, online advertising, and more.

Revenue is the total amount of money a business takes in during a given period by selling goods and services. **Profit** is the amount of money a business earns above and beyond what it spends for salaries and other expenses needed to run the operation. A **loss** occurs when a business's expenses are more than its revenues. If a business loses money over time, it will likely have to close, putting its employees out of work. Over 175,000 businesses in the United States close each year.[1]

In 1979, Geral Fauss took 5,000 oversized foam fingers to the Sugar Bowl in New Orleans not knowing if he would sell a single one. The former high school shop teacher created the now-famous fingers a few years earlier and they became a big hit with his students. Fortunately, the Sugar Bowl crowd liked them, too. He sold every last finger and launched a company that is still going strong. What risks and rewards did Fauss face when starting his business?

The Importance of Entrepreneurs to the Creation of Wealth

An **entrepreneur** is a person who risks time and money to start and manage a business. **Risk** is the chance an entrepreneur takes of losing time and money on a business that may not prove profitable. Successful entrepreneurs not only earn money for themselves; they also provide employment for many other people. Businesses and their employees pay taxes that the federal government and local communities use to build hospitals, schools, libraries, playgrounds, roads, and other public facilities. Taxes also help keep the environment clean, support people in need, and provide police and fire protection. Thus, the wealth businesses generate, and the taxes they pay, help everyone in their communities. A nation's businesses are part of an economic system that contributes to the standard of living of everyone in the country (and, potentially, the world).

Tom Hauck/AP Images

The term **standard of living** refers to the amount of goods and services people can buy with the money they have. For example, the United States has one of the highest standards of living in the world, even though workers in some other countries, such as Germany and Japan, may on average make more money per hour. How can that be? Prices for goods and services in Germany and Japan are higher than in the United States, so a person in those countries can buy less than what a person in the United States can buy with the same amount of money. For example, a bottle of beer may cost $7 in Japan and $4 in the United States.

Often, goods cost more in one country than in another because of higher taxes and stricter government regulations. Finding the right level of taxes and regulation is important in making a country or city prosperous. We'll explore those issues in more depth later in this chapter. At this point, it is enough to understand that the United States enjoys a high standard of living largely because of the wealth created by its businesses.

Responding to the Various Business Stakeholders

Stakeholders are all the people who stand to gain or lose by the policies and activities of a business and whose concerns the business needs to address. They include customers, employees, stockholders, suppliers, dealers (retailers), bankers, people in the surrounding community, the media, environmentalists, competitors, unions, critics, and elected government leaders (see Figure 1.1).

A primary challenge for organizations is to recognize and respond to the needs of their stakeholders. For example, the need for the business to make profits may be balanced against the needs of employees to earn sufficient income or the need to protect the environment. Ignore the media, and they might attack your business with articles that hurt sales. Oppose the local community, and it may stop you from expanding. Pleasing stakeholders is not easy and often calls for trade-offs.

Using Business Principles in Nonprofit Organizations

Despite their efforts to satisfy their stakeholders, businesses cannot do everything needed to make a community all it can be. Nonprofit organizations—such as public schools, civic

profit
The amount of money a business earns above and beyond what it spends for salaries and other expenses.

loss
When a business's expenses are more than its revenues.

entrepreneur
A person who risks time and money to start and manage a business.

risk
(1) The chance an entrepreneur takes of losing time and money on a business that may not prove profitable. (2) The chance of loss, the degree of probability of loss, and the amount of possible loss.

standard of living
The amount of goods and services people can buy with the money they have.

stakeholders
All the people who stand to gain or lose by the policies and activities of a business and whose concerns the business needs to address.

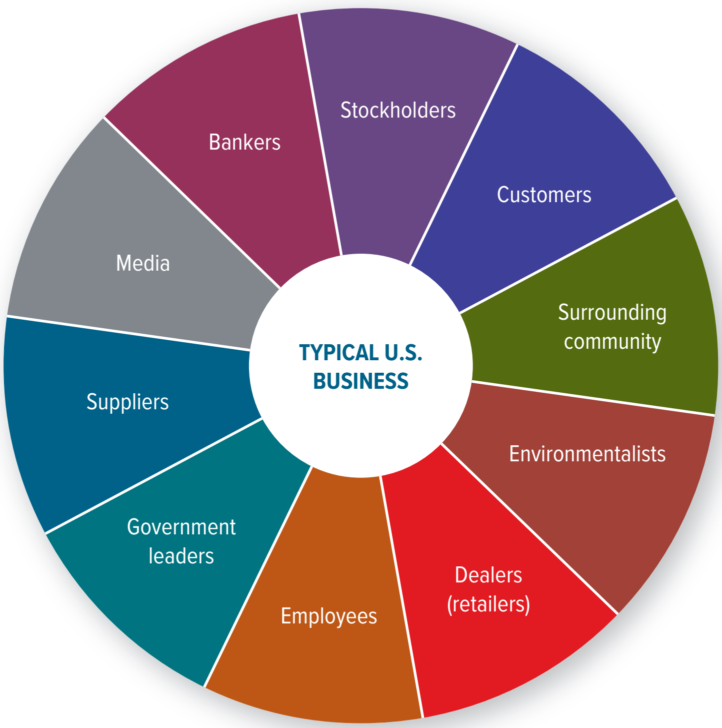

FIGURE 1.1 A BUSINESS AND ITS STAKEHOLDERS
Often the needs of a firm's various stakeholders will conflict. For example, paying employees more may cut into stockholders' profits. Balancing such demands is a major role of business managers.
Source: John Mackey and Raj Sisodia, *Conscious Capitalism* (Boston, MA: Harvard Business Review Press, 2013).

The goals of nonprofit organizations are social and educational, not profit-oriented. The American Red Cross, for example, provides assistance to around 30 million people annually, from refugees to victims of natural disasters. Why do good management principles apply equally to profit-seeking businesses and nonprofit organizations?

JORGE GUERRERO/AFP/Getty Images

nonprofit organization
An organization whose goals do not include making a personal profit for its owners or organizers.

associations, charities like the United Way and the Salvation Army, and groups devoted to social causes—also make a major contribution to the welfare of society. A **nonprofit organization** is an organization whose goals do not include making a personal profit for its owners or organizers. Nonprofit organizations often do strive for financial gains, but they use them to meet their social or educational goals rather than for personal profit.

Your interests may lead you to work for a nonprofit organization. That doesn't mean, however, that you shouldn't study business in college. You'll still need to learn business skills such as information management, leadership, marketing, and financial management. The knowledge and skills you acquire in this and other business courses are useful for careers in any organization, including nonprofits.

TESTPREP

- What is the difference between *revenue* and *profit*?
- What is *risk*, and how is it related to *profit*?
- What is *standard of living*?
- What does the term *stakeholders mean*?

LO 1–2 **Describe how each of the five elements of the business environment affect business.**

The Business Environment

The **business environment** consists of the surrounding factors that either help or hinder the development of businesses. Figure 1.2 shows the five elements in the business environment:

1. The economic and legal environment.
2. The technological environment.
3. The competitive environment.
4. The social environment.
5. The global business environment.

Businesses normally can't control their environment, but they need to monitor it carefully and do what they can to adapt as it changes.

business environment The surrounding factors that either help or hinder the development of businesses.

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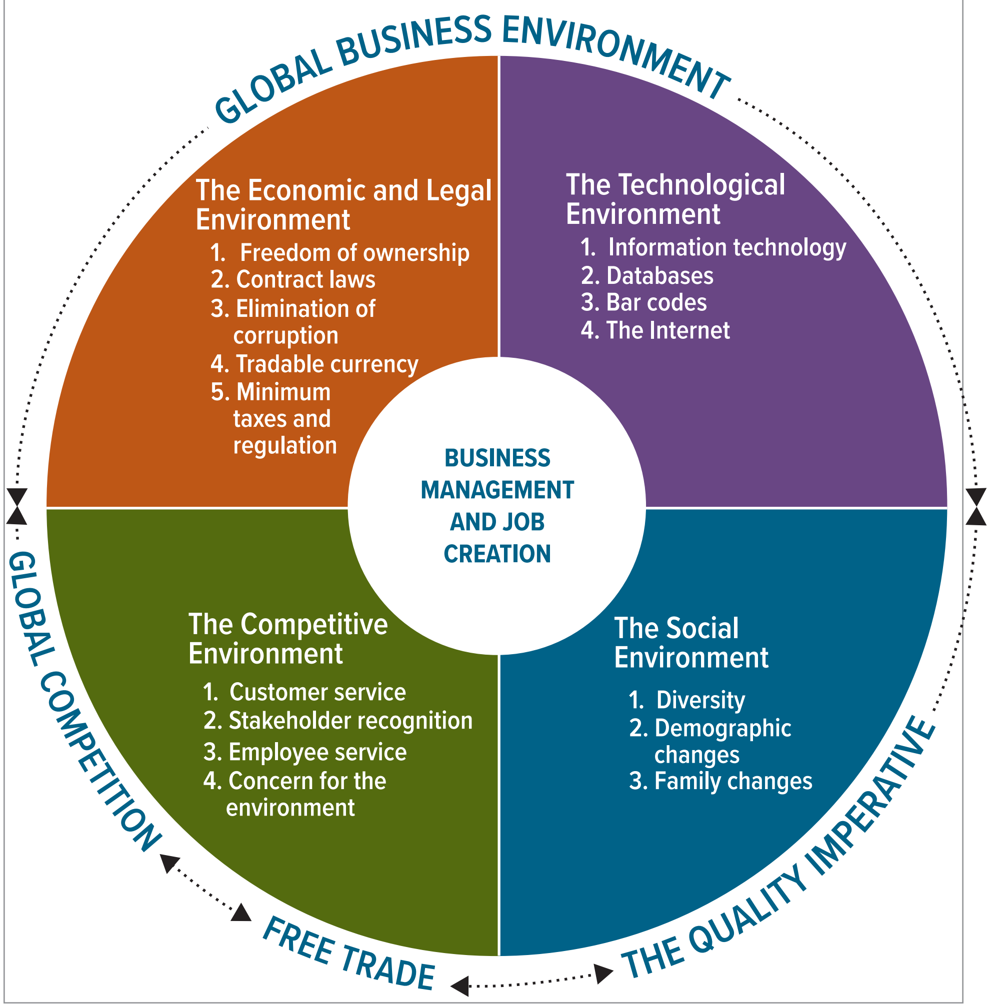
The Economic and Legal Environment

People are willing to start new businesses if they believe the risk of losing their money isn't too great. A country's economic system and laws can have a strong impact on that level of risk. For example, one way government can promote entrepreneurship is to allow private

FIGURE 1.2 TODAY'S DYNAMIC BUSINESS ENVIRONMENT



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Starting a business is more difficult in some countries than in others. In India, for example, it takes a time-consuming and bureaucratic process to obtain government permission. Nonetheless, new businesses can become a major source of wealth and employment. This sari shop is one small example. What do you think would be the effect of a little more freedom to create business opportunities in this country of over a billion people?

Partha Pal/Getty Images

ownership of businesses. In some countries, the government owns most businesses, and there's little incentive for people to work hard or create profit. The legal system regulates what businesses can and cannot do. This includes everything from marketing and product safety to contracts and acceptable business conduct. (You can read more about business laws in Bonus Chapter A.)

The Technological Environment

technology
Everything from phones to computers, medical imaging devices, personal digital assistants, and the various software programs that make business processes more effective, efficient, and productive.

productivity
The amount of output you generate given the amount of input (e.g., hours worked).

Technology means everything from phones to computers, mobile devices, medical imaging machines, robots, the Internet, social media, and the various software programs and apps that make business processes more effective, efficient, and productive.[2] *Effectiveness* means producing the desired result. *Efficiency* means producing goods and services using the least amount of resources. **Productivity** is the amount of output you generate given the amount of input (e.g., hours worked).[3] The Adapting to Change box discusses how one form of technology, drones, can make businesses more effective, efficient, and productive. You can read about how businesses use technology in Chapter 13.

The Competitive Environment

Successful companies strive to offer high-quality products and outstanding service at competitive prices. Businesses have become more customer-driven, not management-driven as often occurred in the past. To meet the needs of customers, firms must understand their needs and wants, establish strong relationships with suppliers, and differentiate themselves from their competitors. We will explore these ideas in more depth in Chapter 11.

The Social Environment

demography
The statistical study of the human population with regard to its size, density, and other characteristics such as age, race, gender, and income.

Demography is the statistical study of the human population with regard to its size, density, and other characteristics such as age, race, gender, and income. The U.S. population is going through major changes that are dramatically affecting how people live, where they live, what they buy, and how they spend their time. Furthermore, tremendous population

ADAPTING TO CHANGE

Up, Up, and Away

Sure, drones can deliver a wide variety of things—everything from your Amazon order to a precisely targeted bomb. But they can also help businesses be more productive and efficient. Drones can scan, map, and gather data, tasks that used to require satellites, planes, and helicopters that only the deepest-pocketed companies could afford. Today even small businesses can pick up a drone for a few hundred dollars.

Construction companies can use drones to collect data far more frequently and accurately than they can with manned aircraft and human surveyors. Farmers can survey their fields of crops. Communication companies can inspect lofty cell towers. Property inspectors can inspect buildings. And this can all be done at much lower costs than traditional methods. For example, building inspectors usually charge $200–$300 for a typical home roof inspection that can take six hours. However, if the inspector uses a drone, the cost is $10 and takes only an hour. And piloting a drone is much less risky than climbing ladders or cell towers.

Jochen Tack/Alamy Stock Photo

Of course, there are many concerns about the use of drones. Drones have been used to buzz planes, endanger military aircraft, and spy on neighbors' property with tiny video cameras. To combat these threats, Congress has proposed giving the Federal Aviation Administration (FAA) more authority to regulate the use of drones. The drone industry is concerned that the lawmakers will inhibit the development and use of drones in their effort to rein in the people who misuse them. What do you think the government should do to regulate drones?

Sources: Michael Larkin, "Commercial Drones Unleashed: New Rules May Spark Industrial Revolution," *Investor's Business Daily,* March 2, 2019; Stephen Rice, "Eyes in the Sky: The Public Has Privacy Concerns about Drones," *Forbes,* February 4, 2019; Andy Pasztor, "FAA Proposes More Commercial Drone Operations at Night and over People," *The Wall Street Journal,* January 14, 2019.

shifts are leading to new opportunities for some firms and to declining opportunities for others. For example, there are many more retired workers than in the past, creating new markets for all kinds of goods and services such as home health care, transportation, recreation, and the like. On the other hand, retired people can drain the economy of wealth. The pay-as-you-go Social Security system (in which workers today pay the retirement benefits for today's retirees) operated just fine in 1940, when 42 workers supported each retiree; but today that number is under 3 and is projected to drop to 2 by 2030.[4] In short, paying Social Security to senior citizens in the future will draw huge amounts of money from the working population.

The Global Environment

The global environment includes all of the international factors that affect business, such as trade agreements, international economic conditions, war and terrorism, climate change, and so forth. The global environment of business is so important that we show it as surrounding all other environmental influences (see again Figure 1.2). World trade, or *globalization,* has grown due to the development of efficient distribution systems (we'll talk about these in Chapter 12) and communication advances such as the Internet (discussed in Chapter 13). World trade has its benefits and costs. You'll read much more about its importance in Chapter 2 and in the Reaching Beyond Our Borders boxes throughout the text.

TESTPREP

- What are the five elements of the business environment?
- What are some ways a country's economic and legal systems affect entrepreneurship?
- What's the difference between effectiveness, efficiency, and productivity?
- How does a changing demography affect business?

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

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

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

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

Mark Conlin/Getty Images

LO 1–3 **Explain basic economics.**

Understanding Economics

Economics is the study of how society chooses to employ resources to produce goods and services and distribute them for consumption among various competing groups and individuals. There are two major branches of economics: **macroeconomics** looks at the operation of a nation's economy as a whole (the whole United States), and **microeconomics** looks at the behavior of people and organizations in markets for particular products or services. A question in macroeconomics might be: What should the United States do to lower its national debt?[5] Macroeconomic topics in this chapter include gross domestic product (GDP), the unemployment rate, and price indexes. A question in microeconomics might be: Why do people buy smaller cars when gas prices go up? Such questions seem easier to answer.

Some economists define economics as the study of the allocation of *scarce* resources. They believe resources need to be carefully divided among people, usually by the government. However, there's no way to maintain peace and prosperity in the world by merely dividing the resources we have today among the existing nations. There aren't enough known resources to do that. **Resource development** is the study of how to increase resources (such as by creating new ways of producing goods, like fish farming or hydroponics) and create conditions that will make better use of them (like recycling and conservation).

The **factors of production** are the resources used to create wealth: land, labor, capital, entrepreneurship, and knowledge (see Figure 1.3):

1. *Land* (or natural resources). Land and other natural resources are used to make homes, cars, and other products.
2. *Labor* (workers). People have always been an important resource in producing goods and services, but many people are now being replaced by technology.
3. *Capital.* This includes machines, tools, buildings, or whatever else is used in the production of goods. It might not include money; money is used to buy factors of production but is not always considered a factor by itself.
4. *Entrepreneurship.* All the resources in the world have little value unless entrepreneurs are willing to take the risk of starting businesses to use those resources.
5. *Knowledge.* Information technology has revolutionized business, making it possible to quickly determine wants and needs and to respond with desired goods and services.

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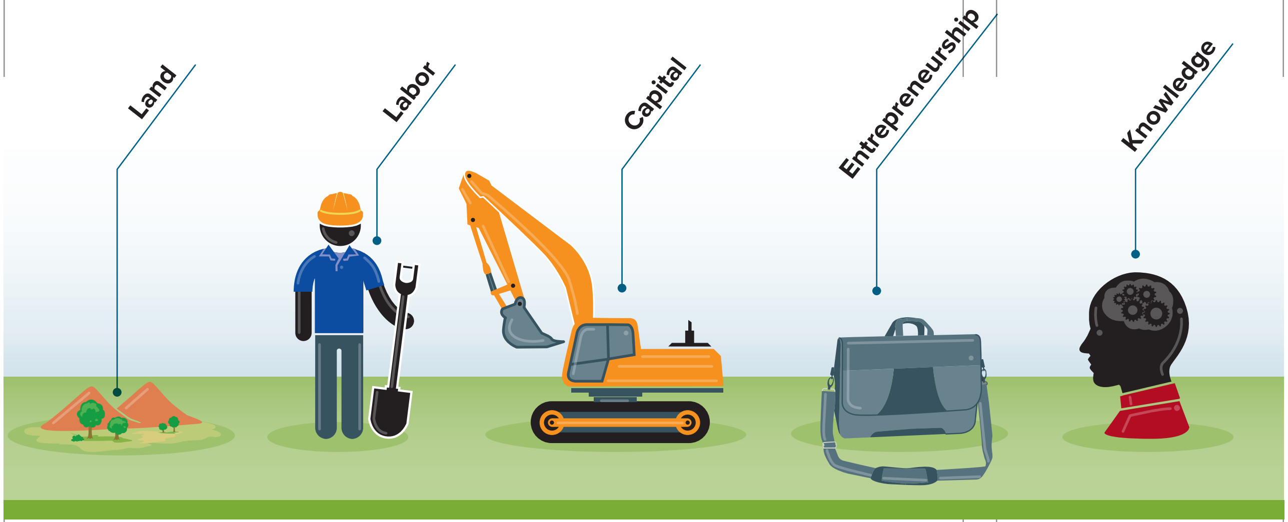
FIGURE 1.3 THE FIVE FACTORS OF PRODUCTION



Source: Drucker Institute, druckerinstitute.com, accessed March 2019.

The various types of economic systems decide differently how to use the factors of production to meet the needs of society. We'll discuss the types of economic systems after the Test Prep.

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

TESTPREP

- What is economics?
- What is the difference between macroeconomics and microeconomics?
- What are the five factors of production? Which ones seem to be the most important for creating wealth?

factors of production The resources used to create wealth: land, labor, capital, entrepreneurship, and knowledge.

LO 1–4 **Compare and contrast the various types of economic systems and explain the trend toward mixed economies.**

Types of Economic Systems

The two types of economic systems today are command economies and free-market economies.

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

Next, we'll take a brief look at each of these economic systems and discuss their benefits and limitations.

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

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

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

Understanding Socialism

Socialism is an economic system based on the premise that some, if not most, basic businesses (e.g., steel mills, coal mines, and utilities) should be owned by the government so that profits can be more evenly distributed among the people. Entrepreneurs often own and run smaller businesses, and individuals are often taxed relatively steeply to pay for social programs.

The major benefit of socialism is more social equality. Free education through college, free health care, and free child care are some of the benefits socialist governments, using

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

Kathy deWitt/Alamy Stock Photo

the money from taxes, may provide to their people. Workers in socialist countries usually get longer vacations, work fewer hours per week, and have more employee benefits (e.g., generous sick leave) than those in countries where free-market capitalism prevails.

Socialism promises to create more equality than capitalism, but it takes away some of businesspeople's incentives since they have to pass on so much of their income to the government (in the form of taxes). This causes many innovators, creative thinkers, doctors, lawyers, business owners, and others who earn a lot of money to leave the country. This loss of the best and brightest people to other countries is called a **brain drain**.

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

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

Understanding Communism

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

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

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

Dmitry Lovetsky/AP Photo

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

Understanding Free-Market Capitalism

Under **capitalism** all or most of the factors of production and distribution are owned by individuals. They are operated for profit, and businesspeople, not government officials, decide what to produce and how much, what to charge, and how much to pay workers. They also decide whether to produce goods in their own countries or have them made in other countries. No country is purely capitalist, however. Often the government gets involved in issues such as determining minimum wages, setting farm prices, and lending money to some failing businesses—as it does in the United States. But capitalism is the *foundation* of the U.S. economic system, and of the economies of England, Australia, Canada, and most other industrialized nations.

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

Capitalism is based on the ideas of Scottish economist Adam Smith. Smith's book *An Inquiry into the Nature and Causes of the Wealth of Nations* (often called simply *The Wealth of Nations*) was published in 1776. Smith believed *freedom* was vital to the survival of any economy, especially the freedom to own land or property and to keep the profits that result from working the land or running a business. He believed people will work long and hard if they have incentives for doing so—that is, if they know they'll be rewarded.[6] As a result of those efforts, the economy will prosper, with plenty of food and all kinds of products available to everyone.

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

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

Kim Karpeles/Alamy Stock Photo

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

Under free-market capitalism, people have four basic rights:

1. *The right to own private property.* This is the most fundamental of all rights under capitalism. Private ownership means that individuals can buy, sell, and use land, buildings, machinery, inventions, and other forms of property. They can also pass on property to their children.
2. *The right to own a business and keep all that business's profits (after taxes).* Profits act as important incentives for business owners.
3. *The right to freedom of competition.* Within certain guidelines established by the government, individuals are free to compete with other individuals or businesses in selling and promoting goods and services.
4. *The right to freedom of choice.* People are free to choose where they want to work and what career they want to follow. Other choices people are free to make include where to live and what to buy or sell.

After years of planning and saving, Jessica Douglass purchased a building with plenty of room to grow and started a business called Flowers and Weeds. The right to own private property and the right to own a business and keep its profits are two of the fundamental rights that exist in the economic system called free-market capitalism. Would either of these rights be viable without the other?

Courtesy of Annie Janssen

One benefit of the four basic rights of capitalism is that people are willing to take more risks than they might otherwise. Another benefit is that it allows open competition among companies. Businesses must provide customers with high-quality products at fair prices with good service. If they don't, they lose customers to businesses that do. The free market—with its competition and incentives—was a major factor in creating the wealth that industrialized countries now enjoy.

Capitalism, like all economic systems, has its faults. For example, income inequality is a major issue that concerns many today.[7] Business owners and managers usually make more money and have more wealth than lower-level workers. Yet people who are older, disabled, or sick may not be able to start and manage a business, and others may not have the talent or the drive. What should society do about such inequality?

The Trend toward Mixed Economies

Although all countries actually have some mix of the two systems, neither free-market nor command economies have resulted in optimal economic conditions. Free-market

FIGURE 1.4 COMPARISONS OF KEY ECONOMIC SYSTEMS

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

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

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mechanisms don't seem to respond enough to the needs of those who are poor, elderly, or disabled. Some people also believe that businesses in free-market economies have not done enough to protect the environment. Over time, free-market countries, such as the United States, have adopted many social and environmental programs such as Social Security, welfare, unemployment compensation, and various clean air and water acts.

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

The trend, then, has been for mostly capitalist countries (like the United States) to move toward socialism (e.g., more government involvement in health care), and for some socialist countries to move toward capitalism (more private businesses, lower taxes). All countries, therefore, have some mix of the two systems. Thus, the long-term global trend is toward a blend of capitalism and socialism. The net effect is the emergence throughout the world of mixed economies.

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

Mixed economies exist where some allocation of resources is made by the market and some by the government. Most countries don't have a name for such a system. If free-market mechanisms allocate most resources, the leaders call their system capitalism. If the government allocates most resources, the leaders call it socialism. Figure 1.4 on the previous page compares the various economic systems.

Like most other nations of the world, the United States has a mixed economy. We'll take a closer look at the U.S. economic system after the Test Prep questions.

TESTPREP

- What are the benefits and drawbacks of socialism?
- How does communism differ from socialism?
- What are the four basic rights that people have under free-market capitalism?
- What are the characteristics of a mixed economy?

LO 1–5 **Describe the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.**

Understanding the U.S. Economic System

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

How Free Markets Work

As we've noted, a free market is one in which decisions about what and how much to produce are made by the market—by buyers and sellers negotiating prices for goods and services. For example, if all of us decided we wanted T-shirts supporting our favorite baseball team, the clothing industry would respond in certain ways. Manufacturers and retailers would increase the price of those T-shirts, because they know people are willing to pay more for the shirts they want. They would also realize they could make more money by making more of those T-shirts. Thus, they have an incentive to pay workers to start earlier and end later. Further, the number of companies making T-shirts would increase. How many T-shirts they make depends on how many we request or buy in the stores. Prices and quantities will continue to change as the number of T-shirts we buy changes.

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

Peter Foley/Bloomberg via Getty Images

The economic concept of demand measures the quantities of goods and services that people are willing to buy at a given price. All else equal, the lower the price, the higher the demand will be. Do you think there would be this many customers rushing to shop on Black Friday if it wasn't for those low-price/low-quantity deals?

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

The Basics of Supply and Demand

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

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

Economists show this relationship between quantity supplied and price on a graph. Figure 1.5 shows a simple supply curve for T-shirts. The price of the shirts in dollars is shown vertically on the left of the graph. The quantity of shirts sellers are willing to supply is shown horizontally at the bottom of the graph. The various points on the curve indicate how many T-shirts sellers would provide at different prices. For example, at a price of $5 a shirt, a T-shirt vendor would provide only 5 shirts, but at $50 a shirt the vendor would supply 50 shirts. The supply curve indicates the relationship between the price and the quantity supplied. All things being equal, the higher the price, the more the vendor will be willing to supply.

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Demand refers to the quantity of products that people are willing to buy at different prices at a specific time. Generally speaking, the quantity demanded will increase as the price decreases. Again, we can show the relationship between price and quantity demanded in a graph. Figure 1.6 shows a simple demand curve for T-shirts. The various points on the graph indicate the quantity demanded at various prices. For example, at $45, buyers

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

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demand just 5 shirts, but at $5, the quantity demanded would increase to 35 shirts. All things being equal, the lower the price, the more buyers are willing to buy.

You might realize from Figures 1.5 and 1.6 that the key factor in determining the quantities supplied and demanded is *price.* If you were to lay the two graphs one on top of the other, the supply curve and the demand curve would cross where quantity demanded and quantity supplied are equal. Figure 1.7 illustrates that point. At a price of $15, the quantity of T-shirts demanded and the quantity supplied are equal (25 shirts). That crossing point is known as the *equilibrium point* or *equilibrium price.* In the long run, that price will become the market price. **Market price**, then, is determined by supply and demand. It is the price toward which the market will trend.

market price
The price determined by supply and demand.

Eventually, supply will equal demand if nothing interferes with market forces. The Making Ethical Decisions box raises an interesting question about when pricing may be a bit out of control and what to do about it.

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

Perfect competition exists when there are many sellers in a market and none is large enough to dictate the price of a product. Sellers' products appear to be identical, such as agricultural products like apples, corn, and potatoes. However, there are no true examples

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

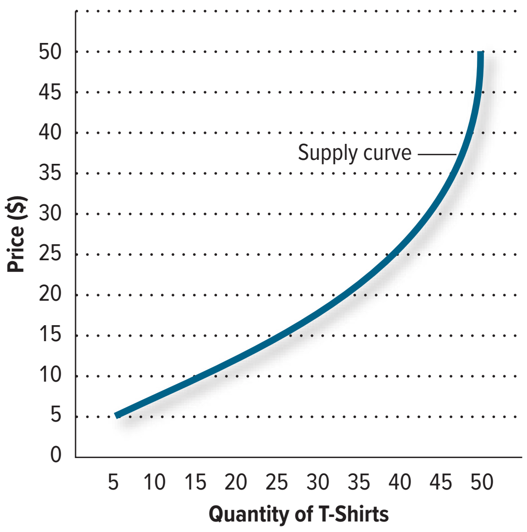


FIGURE 1.5 THE SUPPLY CURVE AT VARIOUS PRICES
The supply curve rises from left to right. Think it through. The higher the price of T-shirts goes (the vertical axis), the more sellers will be willing to supply.

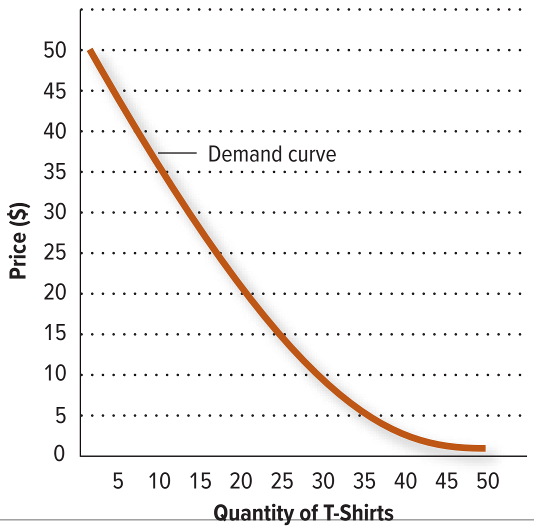


FIGURE 1.6 THE DEMAND CURVE AT VARIOUS PRICES
This is a simple demand curve showing the quantity of T-shirts demanded at different prices. The demand curve falls from left to right. It is easy to understand why. The lower the price of T-shirts, the higher the quantity demanded.

MAKING ETHICAL DECISIONS

Bad Medicine for Consumers?

Your company, a large pharmaceutical firm, acquired a drug called Relivoform when it bought a generic drugmaker. The purchased company was the market's leading supplier of the drug, and it was by far its most profitable product. Relivoform is a major chemotherapy drug important in the treatment of liver cancer. It costs $300 per treatment, and many patients rely on it to control the spread of their cancer.

Currently, your company has many new drugs in development costing the company millions in research and testing. It may be years before the Food and Drug Administration approves the new drugs and you can get them into the market. Your finance committee has recommended increasing the price of Relivoform to $3,000 per treatment to help alleviate the development costs of new drugs. Since your company now controls the distribution of the drug (even though it's a generic), you doubt any competitors could immediately impact your market. When word leaked out that Relivoform's price may increase 10-fold, the public reacted with rage, accusing your firm of favoring profits over patients' needs. Will you follow your committee's recommendation and raise the price? What are your alternatives? What might be the consequences of each?

fluxfoto/Getty Images

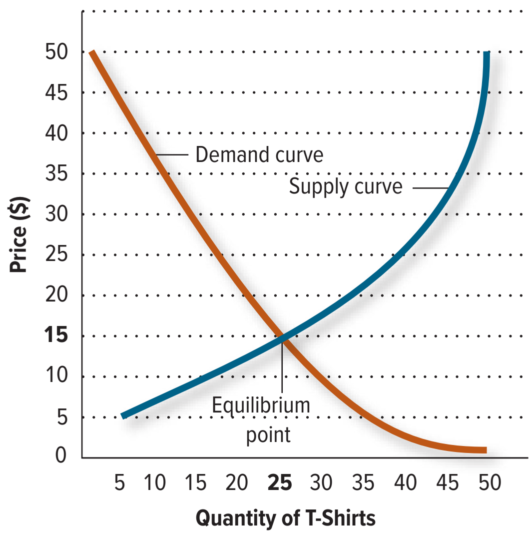


FIGURE 1.7 THE EQUILIBRIUM POINT

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

of perfect competition. Today, government price supports and drastic reductions in the number of farms make it hard to argue that even farming represents perfect competition.

Under **monopolistic competition** a large number of sellers produce very similar products that buyers nevertheless perceive as different, such as hot dogs, sodas, personal computers, and T-shirts. Product differentiation—the attempt to make buyers think similar products are different in some way—is a key to success.

An **oligopoly** is a degree of competition in which just a few sellers dominate a market, as we see in tobacco, gasoline, automobiles, aluminum, and aircraft. One reason some industries remain in the hands of a few sellers is that the initial investment required to enter the business often is tremendous. Think, for example, of how much it would cost to start a new airplane manufacturing facility.

A **monopoly** occurs when one seller controls the total supply of a product or service, and sets the price. In the United States, laws prohibit the creation of monopolies. Nonetheless, the U.S. legal system has permitted monopolies in the markets for public utilities that

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

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

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

sell natural gas, water, and electric power. These companies' prices and profits are usually controlled by public service commissions to protect the interest of buyers.

Key Economic Indicators

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

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

Gross domestic product (GDP) is the total value of final goods and services produced in a country in a given year. Both domestic and foreign-owned companies can produce the goods and services included in GDP, as long as the companies are located within the country's boundaries. For example, production values from Japanese automaker Honda's factory in Ohio are included in U.S. GDP. Revenue generated by Ford's factory in Mexico is included in Mexico's GDP, even though Ford is a U.S. company. Almost every discussion about a nation's economy is based on GDP. If growth in GDP slows or declines, businesses may feel many negative effects. A major influence on the growth of GDP is the productivity of the workforce—that is, how much output workers create with a given amount of input.

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

The **unemployment rate** refers to the percentage of civilians at least 16 years old who are unemployed *and tried to find a job within the prior four weeks.* The unemployment rate was over 7 percent in 2013 and was down below 4 percent in 2019 (see Figure 1.8).[8] Most economists consider a rate of 4 percent or 5 percent to be functionally full employment. However, many argue that the unemployment statistics don't accurately measure the pain being felt by those who have been unemployed for a long time or those who have simply given up looking for a job.[9] This is particularly true of prime-age men between 25 and 54 who neither have jobs nor have looked for one recently.[10]

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

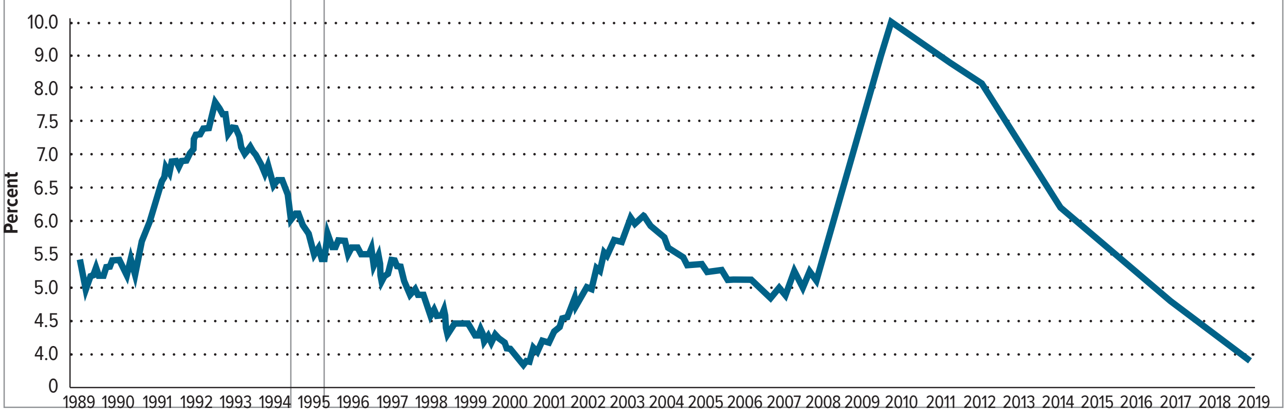
disinflation
A situation in which price increases are slowing (the inflation rate is declining).

deflation
A situation in which prices are declining.

Price indexes help gauge the health of the economy by measuring the levels of inflation, disinflation, deflation, and stagflation. **Inflation** is a general rise in the prices of goods and services over time. The official definition is "a persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of goods and services."[11] Thus, it is also described as "too many dollars chasing too few goods." Rapid inflation is scary. If the prices of goods and services go up by just 7 percent a year, they will double in about 10 years. The Reaching Beyond Our Borders box highlights several examples of inflation out of control. In fact, way out of control.

Disinflation occurs when price increases are slowing (the inflation rate is declining). That was the situation in the United States throughout the 1990s. **Deflation** means that prices are declining. It occurs when countries produce so many goods that people cannot afford

FIGURE 1.8 U.S. UNEMPLOYMENT RATE 1989–2019



REACHING BEYOND **OUR BORDERS**

Inflation at the Speed of Sound

If you are familiar with the Rule of 72, you know it's a simple way to measure how long it would take for prices to double at a given rate of inflation. For example, if inflation is growing at 6 percent a year, prices would double in 12 years (6 divided into 72). This would be an unacceptable inflation rate in the United States, where the Federal Reserve targets keeping price increases at 2 percent (or less) a year. Well, what if prices went up 221 percent in one month? Impossible? Unfortunately, not in Venezuela, which is the most recent example of hyperinflation.

Hyperinflation is when the price of goods and services rises by 50 percent a month. It often starts when a country's government prints more money to pay for excess spending. In Venezuela, prices increased by 63 percent in 2014, 121 percent in 2015, 481 percent in 2016, 2,616 percent in 2017, 80,000 percent in 2018, and over 10,000,000 percent in 2019! In fact, things got so bad that Venezuela's currency, the bolivar, collapsed so low that cash to pay for goods and services was being weighed instead of counted. The country is now facing shortages of food and medicine, with children being affected harshly.

Manaure Quintero/Bloomberg via Getty Images

Venezuela is not the first country to suffer the ravages of hyperinflation. German hyperinflation was a classic example after World War I, when prices were doubling every three days. Pictures of Germans pushing wheelbarrows full of marks (German currency) to buy a loaf of bread were common. Zimbabwe had hyperinflation from 2004 to 2009. Its economy faced an inflation rate of 98 percent a day, with prices doubling every 24 hours.

The price of a Big Mac or cup of Starbucks coffee doubling every day doesn't sound great to us. Let's hope the Federal Reserve stays vigilant against inflation and keeps our rate at or below 2 percent.

Sources: Juan Forero, "Hyperinflation Shatters Venezuelan Manufacturing," *The Wall Street Journal,* March 5, 2019; Steve Hanke, "Venezuela's Hyperinflation Hits 80,000% per Year in 2018," *Forbes,* January 1, 2019; Girish Gupta, "Venezuela 2017 Annual Inflation at 2,616 Percent," Reuters, January 8, 2018; Garth Friesen, "The Path to Hyperinflation: What Happened to Venezuela?," *Forbes,* August 7, 2018; Seana Davis, Emmanuelle Saliba, and Alex Morgan, "Venezuela: All My Life's Savings Were Destroyed by Hyperinflation," *EuroNews,* February 15, 2019.

to buy them all (too few dollars are chasing too many goods). While declining prices might sound good, it's an indication that economic conditions are deteriorating.[12] **Stagflation** occurs when the economy is slowing but prices are going up anyhow.[13]

The **consumer price index (CPI)** consists of monthly statistics that measure the pace of inflation or deflation. The government can compute the cost of goods and services, including housing, food, apparel, and medical care, to see whether or not they are going up or down.[14] Today, however, the government is relying more on the measure of **core inflation**. That means the CPI minus food and energy costs. Since the cost of food and energy can have temporary price shocks, the inflation measures reported (core inflation) are actually lower than real costs. The CPI is important to you because some wages and salaries, rents and leases, tax brackets, government benefits, and interest rates are based on this data.

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

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

core inflation
CPI minus food and energy costs.

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

The **producer price index (PPI)** measures the change in prices at the wholesale level. It tracks price changes in nearly all industries in the goods-producing sectors of the U.S. economy.[15] Other indicators of the economy's condition include housing starts, retail sales, and changes in personal income. You can learn more about such indicators by reading business periodicals, listening to business broadcasts on radio and television, and exploring business sites online.

The Business Cycle

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

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

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

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

depression
A severe recession, usually accompanied by deflation.

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

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

TESTPREP

- In a free-market economy, how do businesspeople know what to produce and in what quantity?
- How are prices determined?
- Name the three economic indicators and describe how well the United States is doing based on each indicator.
- What's the difference between a recession and a depression?

LO 1–6 Contrast fiscal policy and monetary policy, and explain how each affects the economy.

Stabilizing the Economy through Fiscal Policy

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

Fiscal policy refers to the federal government's efforts to keep the economy stable by increasing or decreasing taxes or government spending. When the government employs fiscal policy it is following the basic economic theory of John Maynard Keynes.[16] **Keynesian economic theory** is the theory that a government policy of increasing spending and cutting taxes could stimulate the economy in a recession.[17]

The first fiscal policy tool is taxation. Theoretically, high tax rates tend to slow the economy because they draw money away from the private sector and put it into the government. High tax rates may discourage small-business ownership because they decrease the profits businesses can earn and make the effort less rewarding. It follows, then, that low tax rates will theoretically give the economy a boost.

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

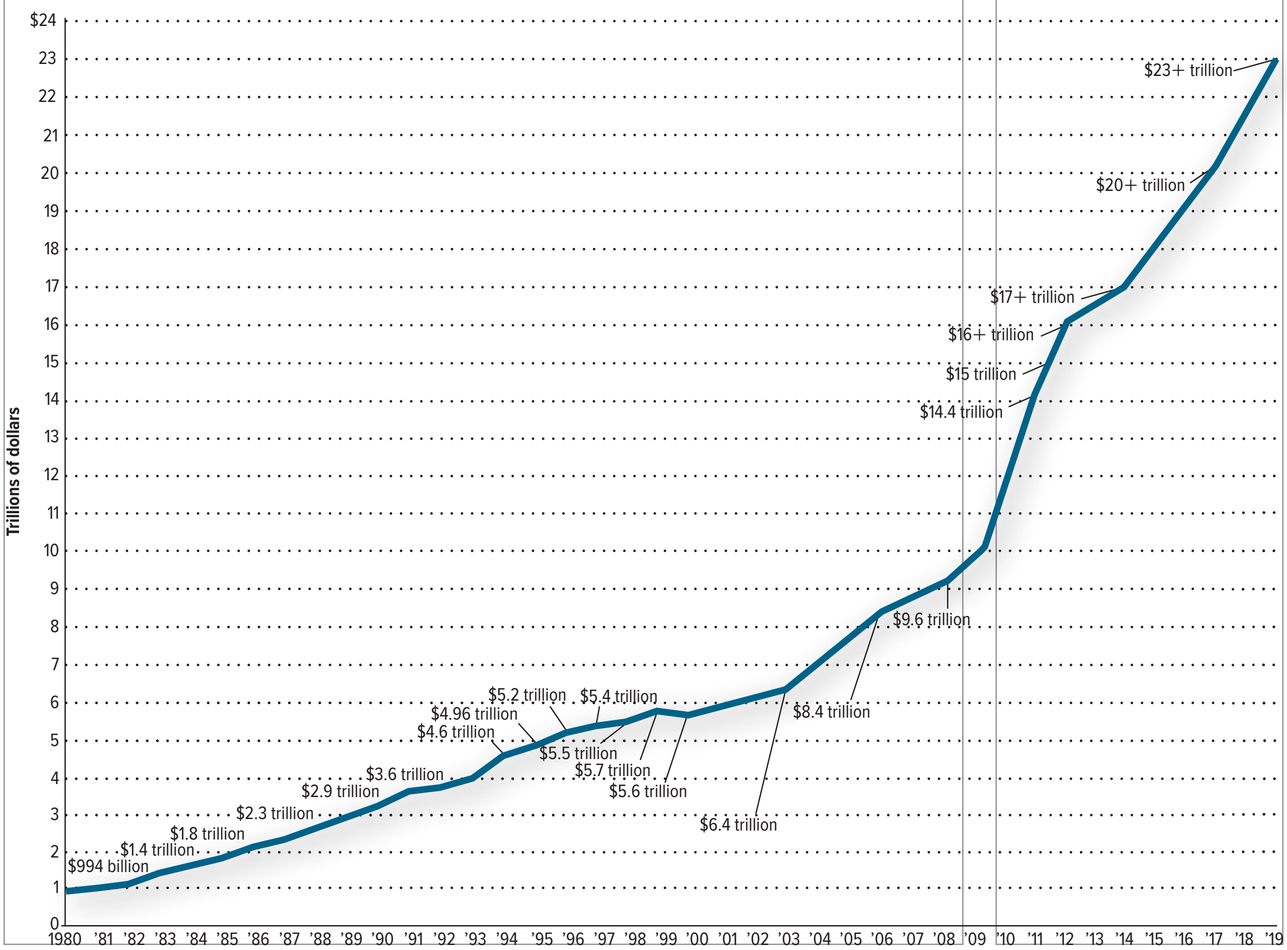
The second fiscal policy tool is government spending on defense, social programs, education, infrastructure (e.g., roads, bridges, and utilities), and so on. Such spending, however, can increase the national deficit.[18] The national deficit is the amount of money the federal government spends beyond what it collects in taxes for a given fiscal year.[19] The deficit was almost $600 billion in 2016. It ballooned to over $800 billion in 2018 and was $1.1 trillion in 2020.[20] Economists attribute this increased deficit to less money coming in due to recent tax cuts and more money going out due to retiring Baby Boomers and health care costs.[21] Such deficits increase the national debt. The **national debt** is the sum of government deficits over time. The national debt is now almost $23 trillion (see Figure 1.9).[22] If the government takes in more revenue than it spends (i.e., tax revenues exceed expenditures), there is a national *surplus.* That is not likely to happen soon.

national debt
The sum of government deficits over time.

Using Monetary Policy to Keep the Economy Growing

Have you ever wondered what organization adds money to or subtracts money from the economy? The answer is the Federal Reserve Bank (the Fed). The Fed is a semiprivate organization that is not under the direct control of the government but does have members

FIGURE 1.9 THE NATIONAL DEBT



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

appointed by the president. We will discuss the Fed in detail when we look at banking in Chapter 16. Now we simply introduce monetary policy and the role of the Fed in controlling the economy. **Monetary policy** is the management of the money supply and interest rates by the Federal Reserve Bank. The Fed's most visible role is the raising and lowering of interest rates. When the economy is booming, the Fed tends to raise interest rates. This makes money more expensive to borrow. Businesses thus borrow less, and the economy slows as businesspeople spend less money on everything they need to grow, including labor and machinery. The opposite is true when the Fed lowers interest rates. Businesses tend to borrow more, and the economy is expected to grow. Raising and lowering interest rates should help control the rapid ups and downs of the economy.

The Fed also controls the money supply. A simple explanation of this function is that the more money the Fed makes available to businesspeople and others, the faster the economy is supposed to grow. To slow the economy (and prevent inflation), the Fed lowers the money supply.

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

TESTPREP

- How does the government manage the economy using fiscal policy?
- What does the term *monetary policy* mean? What organization is responsible for monetary policy?

LO 1–7 Review how past trends are being repeated in the present and what those trends mean for tomorrow's college graduates.

The Evolution of U.S. Business

Businesses in the United States have become so productive that they need fewer workers than ever before to produce goods. If global competition and improved technology are putting skilled people out of work, should we be concerned about the prospect of fewer jobs and lower incomes? Where will the jobs be when you graduate? These important questions force us all to look briefly at the U.S. economy and its future.

Progress in the Agricultural and Manufacturing Industries

The United States has experienced strong economic development since the 1800s. The agricultural industry led the way, providing food for the United States and much of the world. Cyrus McCormick's invention of the harvester in 1834, other inventions such as Eli Whitney's cotton gin, and modern improvements on such equipment did much to make large-scale farming successful. Technology has made modern farming so efficient that the number of farmers has dropped from about 33 percent of the population to less than 1 percent today.

Rev. Confirming Pages

Richard Hamilton Smith/Newscom

Agriculture is one of the largest and most important industries in the United States. Technology has increased productivity and made farmers more efficient, allowing for larger farms. This trend has helped reduce the increase in price of some foods for consumers, but has also reduced the number of small, family-run farms. Does the new technology also help smaller farms compete? If so, how?

Agriculture is still a major industry in the United States. What has changed is that the millions of small farms that existed previously have been replaced by some huge farms, some merely large farms, and some small but highly specialized farms. The loss of farmworkers over the past century is not a negative sign. It is instead an indication that U.S. agricultural workers are the most productive in the world.

Most farmers who lost their jobs during the 19th and 20th centuries went to work in factories springing up around the country. Manufacturers, like farms, began using new technology, new tools, and machines to become more productive. Eventually the consequence in manufacturing, as in farming, was the elimination of many jobs.

Again, the loss to society is minimized if the wealth created by increased productivity and efficiency creates new jobs elsewhere—and that's exactly what has happened over the past 50 years. Many workers in the industrial sector found jobs in the growing service sector. Most of those who can't find work today are people who need retraining and education to become qualified for jobs that now exist or will exist in the near future, such as building wind farms or making electric cars. We'll discuss the manufacturing sector and production in more detail in Chapter 8.

Progress in the Service Industries

In the past, the fastest-growing industries in the United States produced goods like steel, automobiles, and machine tools. Today, the fastest-growing firms provide services in areas such as law, health, telecommunications, entertainment, and finance.

Together, services make up nearly 80 percent of the value of the U.S. economy. Since the mid-1980s, the service industry has generated almost all the increases in employment. Although service-sector growth has slowed, it remains the largest area of growth. Chances are very high that you'll work in a service job at some point in your career.[23] Figure 1.10 on the next page lists many service-sector jobs; look it over to see where the careers of the future are likely to be.

Another bit of good news is that there are *more* high-paying jobs in the service sector than in the goods-producing sector. High-paying service-sector jobs abound in health care, accounting, finance, entertainment, telecommunications, architecture, law, software engineering, and more.[24] Projections are that some areas of the service sector will grow rapidly, while others may have much slower growth (see the Adapting to Change box on the next page). The strategy for college graduates is to remain flexible, find out where jobs are being created, and move when appropriate.

Your Future in Business

Despite the growth in the service sector we've described above, the service era now seems to be coming to a close as a new era is beginning. We're in the midst of an information-based global and technical revolution that will alter all sectors of the economy: agricultural, industrial, and service. It's exciting to think about the role you'll play in that revolution. You may be a leader who will implement the changes and accept the challenges of world competition based on world quality standards. This book will introduce you to some of the concepts that make such leadership possible, not just in business but also in government agencies and nonprofit organizations. Business can't prosper in the future without the cooperation of government and social leaders throughout the world.