THIRD EDITION

Introduction to BUSINESS

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Richard T. Hise • L. Murphy Smith • Antonio Arreola-Risa

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Dedications

To Jayanthi, Philip, and Jeremy
—Julian E. Gaspar

To Risa, Joshua, and David
—Leonard Bierman

To Karie and Wes
—James W. Kolari

To Carol, Amy, and Emily
—Richard T. Hise

To Mary Katherine, Tracy, David, Susan, Jacob, Hannah, Alex, Katherine, Penelope, Forrest, Charlotte, Walter, Lawrence, Cora, Liam, and Harper
—L. Murphy Smith

To Cecivon, Cecivonita, Tony, Maui, and Alex
—Antonio Arreola-Risa

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Brief Contents

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Preface

Understanding and explaining how the business world operates involves many challenges for both instructors and students. This third edition of the *Introduction to Business* provides students with a rewarding educational experience and sets the stage for pursuing a successful business career.

Any business, big or small, is fraught with risk, and unless students have a clear understanding of contemporary business principles, they will be taking unnecessary risks that could lead to business failure. Understanding the pillars of the business environment—globalization, technology, and ethics—is crucial to success. This book introduces students to the art and science of managing a business today—and in a way that is interesting, relevant, and engaging.

A Team of Experts Can Make a Difference

The introduction to business course covers a lot of ground, touching on the macro and micro economic environments as well as all the major functional areas of business. We recognize that it is a challenge for students to understand how all the different functional areas are interrelated in the current digital era, and it is a test for an instructor to cover all these areas with equal amounts of enthusiasm and expertise. Most introduction to business texts are written by authors who have expertise in one, two, or perhaps three functional areas of business. Our text is unique in that it has an author team of six functional area experts. We meet regularly as a team to discuss contemporary business developments, review manuscript, examine market feedback, and make sure that we have created a current, cohesive, comprehensive, authoritative presentation of business that is unparalleled in the market. Helping us all the way in this process—making sure that the material is presented consistently and clearly—has been our lead author. He has taught thousands of business students and understands the challenges they and you, the instructor, face in our digital global economy.

Goals and Themes of the Book

Throughout the planning and writing of the *Introduction to Business*, 3e, we have sought and listened to the advice of instructors across the country who have taught this course for many years. We have also sought student feedback to be sure the content is appealing and relevant to millennials. As a result, the features of this book have been carefully designed with the latest technology to respond to both student and instructor needs.

Key Themes

Anyone who listens to the news and follows current business events knows that contemporary business, regardless of where it is conducted, is heavily influenced by rapid globalization (despite the recent rise of populism), advances in technology (especially digital information technology), and enforcement of ethical business standards. With globalization, the notion of the purely domestic firm has become a myth. Similarly, rapid advances in technology, in the form of social media, electronic commerce, algorithmic information technology operations, supply chain management, electronic banking, and so on, are quickly transforming the way businesses operate to be successful. There is hardly any business or business function that is "technology insensitive." Finally, firms need to be ethically managed if they are to survive, deliver value to investors and customers alike, and be successful in the long term. To be successful in business—today and in the foreseeable future—students need a text that fully integrates these three themes within all aspects of business. That is why we have embraced these concepts through numerous in-text examples as well as boxed features throughout.

A Focus on Integrated Examples

Another unique feature of the *Introduction to Business*, 3e, is weaving the strategies and operations of three major global companies—Shell, McDonald's, and Samsung—throughout the text so that students can follow how the topics at hand, across different functional areas, relate to these real-world examples. These three companies, which most students have already heard of, reflect three important regions of the world: Europe (Shell), North America (McDonald's), and Asia (Samsung). Also, these three companies are following extremely challenging and interesting business strategies to maintain leadership in their respective fields. *Case in Point* features throughout the book follow these three companies. Many of these features also touch on the themes of globalization, technology, and ethics.

Accessible, Relevant Text

Since the *Introduction to Business*, 3e, is an introductory business text, we have strived to keep the narrative conversational and concise. Reviewers have commented positively about the readability of the text. We hope this text will be "user friendly" so that students will read the chapters regularly and come to class well prepared. Every aspect of the *Introduction to Business*, 3e, aims at getting the reader to think deeply about the subject and how it relates to everyday business—the contemporary environment of business as well as the functional areas of business operations. Our primary goal is to help the reader fully appreciate business fundamentals and pursue a career in business—either as an entrepreneur or as an employee.

New Material on Up-to-Date Topics

Keeping abreast of current issues is vital to make a text relevant and interesting. Examples of new business trends or issues that we have identified and included in the *Introduction to Business*, 3e, are:

- The important role knowledge workers play in contemporary digital economy
- Why emerging economies are a great source of business opportunity
- The measurement and impact of consumer confidence on business
- The importance of understanding consumer demographics and psychographics in business
- How to infuse cultural diversity to enhance business performance
- How to utilize purchasing power parity to determine business potential
- How algorithmic IT operations platforms are changing the business world
- Why trade is better than no trade for society as a whole
- The rationale behind a country's choice of exchange-rate regimes
- The evolution of globalization, the rise of populism and their impact on business
- The rising importance of shareholder and institutional investors activism in corporate governance
- The Sarbanes-Oxley Act, Regulation FD, and other recent governmental rules in the corporate governance area

- Business ethics training and the impact of recent business ethics scandals on college campuses
- Cyber security and contingency planning in the post-9/11 era
- Current military and foreign policy examples to help teach organizational structure material
- Six Sigma initiatives initiated by General Electric and adopted by other leading companies as quality control mechanisms
- U.S. Supreme Court–University of Michigan affirmative action cases and the impact of 9/11 on workforce diversity
- Off-duty conduct statutes and other state-level regulation of human resources management
- The pros and cons of contemporary work-life programs
- How major leadership theories impact leadership styles
- Why share of wallet is being increasingly used as a measure of customer purchasing patterns
- The greater emphasis companies are placing on maximizing the value of their brand equity
- Key elements of the financial process for making business investment decisions
- Advice on how to wisely invest your money in the financial markets
- Electronic money and how to protect yourself from identity theft
- The role of central banks and their effects on the economy, businesses, and individuals
- How management information systems can create value for businesses and customers
- The increasing ubiquity of enterprise resource planning systems
- The redefinition of business competition via supply chain management
- The emergence of digital enterprises
- The impacts of Amazon's online product sales on brick and mortar firms
- Recent large bank mergers and the financial system
- Central bank independence in the age of populism
- Smartphone mobile payments innovations
- The advent of cryptocurrencies such as Bitcoin
- Ongoing changes in health care insurance policies
- Artificial intelligence and how they make marketing and logistic decisions better
- Digital marketing's impact on advertising expenditures
- Amazon's use of drones to deliver goods to customers
- Use of social media to promote products and services
- Uber: going beyond ride-sharing
- Disruptive technologies to shake up complacent companies and industries
- Thinking machines and how companies are experimenting with autonomous robots

The Features That Are the Keys to Success

Part and Chapter Openers

Each of the six parts in the *Introduction to Business*, 3e, addresses a broad topic, and the part-opening text gives students an overview of what is going to be covered and helps link the different parts together. Each chapter begins with a *Chapter Outline* and a list of

Learning Objectives to help direct student reading. The learning objectives are repeated in the margins of the chapter text so that students can map their progress through the chapter. The chapter *Summary* is also organized by the learning objectives to help students retain their focus on key issues.

Chapter-Opening Vignettes

Each chapter opens with a short but interesting story—something that students can relate to easily—that corresponds to the chapter's topic. Within the chapter, reference is made to the chapter openers to connect the opening story to chapter content.

Case in Point and Theme Features

Each chapter includes at least one *Case in Point* feature focused on Shell, McDonald's, or Samsung. Each chapter also contains at least one boxed feature that deals with one of the three themes—*Global Business*, *Technology and Business*, and *Ethics in Business*. Every feature concludes with questions that encourage students to think about what they have read and that can lead to interesting in-class discussion.

Graphics, Color, and Real Examples

The layout of the *Introduction to Business*, 3e, has been designed for clarity, with an uncluttered, sophisticated look. At the same time, this streamlined approach is enhanced with color and graphics meant to heighten interest in the topics and focus the reader's attention on the most important business concepts. Real-world examples throughout the text show how the topic at hand impacts big and small businesses. The important roles that globalization, technology, and ethics play in the future of business stand out because of these features.

Marginal Notes

The introduction to business course is chock-full of terms that are new to students. To make this new vocabulary more accessible, all key terms appear in bold type in the chapters and are defined clearly in the text, marginal notes, and the comprehensive glossary at the end of the text.

Reality Check

Each learning objective section ends with a *Reality Check*, a question that asks students how that section's learning objective impacts them in the real world. Because business issues are brought to this personal level, students are more likely to be engaged.

End-of-Chapter Pedagogy

The end-of-chapter pedagogy carefully reinforces the relevance of chapter content, as well as the learning of terminology, concepts, business environment, and operations. A menu of assignments allows instructors to choose which activities are most appropriate for their course.

Careers

Directly preceding the *Summary* for each chapter is a section devoted to career opportunities in that chapter's business field. Students are informed about the various job possibilities available in that area of business and provided with tips on how to go about the job search.

Chapter Summary

Each chapter *Summary* is organized according to the learning objectives. By the time students finish going through the *Summary*, they will have read the learning objectives at least three times and will know where to find the required information related to the objectives.

Key Terms List

Each chapter introduces new key terms and concepts relevant to the topic of discussion. For ease of reference, all those key terms are defined and listed in the end-of-chapter section of the text.

Chapter Questions

Chapter Questions help students recall business concepts, understand how these concepts are applied, and challenge students to use judgment when developing their answers.

Interpreting Business News

Given typical and/or current business news items that readers would find in periodicals such as *The Wall Street Journal*, *Financial Times*, *Bloomberg Businessweek*, and so on, students are required to interpret what the news item means, using their understanding of the material covered in that chapter.

Web Assignments

Students are directed to visit the websites of specific companies to extract the information necessary for answering chapter-based business questions.

Portfolio Projects

To help students build their own business portfolio, one or both of the *Portfolio Projects* may be assigned as individual or group activities that span the course. The objective of *Exploring Your Own Case in Point* is to encourage and enable students to conduct a comprehensive analysis of a large company (e.g., a *Fortune 500* company). Students select a company of interest that is publicly traded and obtain information that is readily available on the Web and from library sources. By answering chapter-specific questions in these sections, students will have conducted a comprehensive analysis of the company by the end of the course. The questions in *Starting Your Own Business* are intended to provide students with the opportunity to put together a comprehensive business plan—the first step in the start-up of a new commercial enterprise. The objective here is to enable students to become successful entrepreneurs by helping them to establish clear business goals, strategies, and methods of operation.

Test Prepper

Professors and students alike have lauded this feature as one that is unique and that truly adds value to the book. Without having to purchase an extra study guide, students can test their comprehension of a chapter's subject matter by using these true/false and multiple-choice questions.

Organization and Topical Coverage of the Text

The contents of the *Introduction to Business*, 3e, have been arranged so that each chapter builds on the substance of previous chapters. In addition, each topic is covered by explaining business fundamentals carefully before getting into examples and other details. The logical sequence of the parts and chapters follows.

Part 1, The Nature of Contemporary Business, provides a four-chapter introduction to what business—large and small—is all about. Chapter 1, *What Is Business?* defines business in terms of for-profit and not-for-profit organizations and how they operate in different types of economic systems. We explain concepts such as inputs, outputs, and how business performance is measured in a consumer-driven market economy that operates in the digital era. In Chapter 2, *The Environment of Business*, we explain carefully why business is global in nature regardless of the type and location of business activity. We show that with falling trade and investment barriers, and advances in information technology, we live in a global village where outsourcing of goods and services is the norm and where ethical businesses will thrive. Chapter 3, *Business Governance, Ethics, and Social Responsibility*, takes an up-to-date look at business governance structures and the potential conflicts of interest that exist within these structures. It also examines business codes of ethics and how companies are seeking to promote better ethical behavior on the part of their employees. In Chapter 4, *Small Business and Entrepreneurship*, we discuss the critical role of small business in the economy, government support for small business, what kind of individuals become successful entrepreneurs, how to develop a viable business plan and set up a small business organization, and key management decisions of small businesses. This chapter is geared toward providing ingredients essential to starting a small business and includes many real-world examples of entrepreneurs and their business operations.

Part 2, Managing Business Behavior, includes three chapters and examines the specifics of managing business—since all firms need to be managed. In Chapter 5, *Managing and Organizing Business*, students learn about the basic managerial functions of planning, organizing, directing, and controlling. This chapter also discusses the different types of managers and management skills that are needed to run a business successfully. Chapter 6, *Human Resources Management*, explores the management of people in organizations. Issues such as recruiting employees, setting their wages and benefits, the legal environment of human resources management, and workplace diversity in the post-9/11 era are all discussed. In Chapter 7, *Motivating and Leading Employees*, we focus on the crucial role motivation and leadership play in business success. After defining motivation, we examine major motivation theories from the perspective of how employee job satisfaction and performance can be enhanced. Special attention is also given to how businesses can implement work-life programs, which can allow employees to best balance present-day work with family lives. This part concludes with a comprehensive analysis and discussion of major leadership theories and leadership styles, along with an examination of the importance that ethics plays in this function.

Part 3, Marketing, provides students with a three-chapter introduction to this important business responsibility. Chapter 8, *Marketing Basics*, describes the various types of markets that companies can elect to serve, what comprises the marketing environment, how information is gathered about markets and the environment, what objectives marketing executives pursue, what strategies they might employ (e.g., social media) to achieve those objectives, and how to effectively manage customers. Chapter 9, *Developing the Product and Pricing Mixes*, deals with the product and pricing elements of the marketing mix. It familiarizes students with the basic aspects of products. The new product development process is presented, as are ways to effectively manage existing products. We discuss pricing objectives, along with basic pricing concepts. Chapter 10, *Developing the Promotion and Distribution Mixes*, provides coverage of the other marketing mix elements—promotion and distribution. It contains a discussion of the promotion mix. Integrated marketing promotion programs are emphasized, as are the advantages and disadvantages of using or not using channels of distribution, such as e-commerce. The importance of direct marketing is also identified, and the increasing attention being paid to logistics and supply chain management by the business world is discussed.

Part 4, Accounting, consisting of two chapters, describes the role of accounting to people within and outside the business firm. Chapter 11, *Accounting for Decision Making*, describes how the accounting information system contributes to developing a sound organizational structure, ensures that employees are held responsible for their actions, and maintains cost-effective business operations. Outside the firm, external users such as investors and lending institutions use financial statements to make investment and loan decisions. In Chapter 12, *Financial Reporting*, we focus on the four financial statements: the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows. Together, these four financial statements represent a business firm in financial terms and provide information that people need to make effective business decisions.

Part 5, Finance, includes three chapters that review important elements of finance applicable to business firms, investors, and individuals. In Chapter 13, *Financial Management of the Firm and Investment Management*, we consider how companies raise funds for investment and evaluate the best way to invest those funds. We also examine how investors who purchase the debt and equity of firms assess how well financial managers are performing their duties. Chapter 14, *Understanding the Financial System, Money, and Banking*, looks at the bigger picture of the financial system as a whole. The financial system is composed of financial markets, institutions, and instruments. We show how financial systems affect the lives of individuals and the success of business firms. Chapter 15, *Personal Financial Planning*, covers important principles of personal financial planning, which involves gathering all of your financial and personal data, analyzing that data, and creating a financial plan for the future. This hands-on chapter can help any individual to achieve a sound personal financial plan.

Part 6, Managing Business Operations, Management Information Systems, and the Digital Enterprise, includes three independent yet interrelated chapters. In Chapter 16, *Managing Business Operations*, students are exposed to the operations function and to how good management of this function leads to competitive advantage for the firm and to value creation for the firm's customers. We explain the key operations management decisions in regard to product, process, capacity, location, layout, production rate, material requirements, purchasing, inventory, scheduling, and quality. In Chapter 17, *Management Information Systems*, students are introduced to the major elements of contemporary management information systems: computer hardware, computer software, databases, and telecommunications networks. Management information systems are then classified by the type of manager or the business function that they serve. The chapter also addresses the development of information systems, the strategies for the globalization of information systems, and the activities that firms perform to ensure the security and accuracy of their information systems. In Chapter 18, *The Digital Enterprise*, we examine attempts by companies to digitally integrate across business functions via enterprise resource planning systems, across firms via supply chain management, and with their customers and partners via e-business. This chapter offers evidence to students that, for the digital enterprise, the future is already here.

Online and in Print

Student Options: Print and Online Versions

This third edition of *Introduction to Business* is available in multiple versions: online, in PDF, and in print as either a paperback or loose-leaf text. The content of each version is identical.

The most affordable version is the online book, with upgrade options including the online version bundled with a print version. The benefit of the print version is that it offers you the freedom of being unplugged—away from your computer. Academic Media Solutions recognizes that it is difficult to read from a screen at length and that most of us read much faster when reading printed materials. The print version is particularly useful when you have extended print passages to read.

The online edition allows you to take full advantage of embedded digital features, including search and notes. Use the search feature to locate and jump to discussions anywhere in the book. Use the notes feature to add personal comments or annotations. You can move out of the book to follow Web links. You can navigate within and between chapters using a clickable table of contents. These features allow you to work at your own pace and in your own style as you read and surf your way through the material. (See "Harnessing the Online Version" for more tips on working with the online version.)

Harnessing the Online Version

The online version of the *Introduction to Business* offers the following features to facilitate learning and to make using the book an easy, enjoyable experience:

- ***Easy-to-navigate/clickable table of contents***—You can surf through the book quickly by clicking on chapter headings, or first- or second-level section headings. The table of contents can be accessed from anywhere in the book.

- ***Key terms search***—Type in a term, and a search engine will return every instance of that term in the book, then jump directly to the selection of your choice with one click.
- ***Notes and highlighting***—The online version includes study apps such as notes and highlighting. Each of these apps can be found in the tools icon embedded in the Academic Media Solutions/Textbook Media's online eBook reading platform (www.academicmediasolutions.com).
- ***Upgrades***—The online version includes the ability to purchase additional study apps and functionality that will enhance the learning experience.

Supplements for Instructors

In addition to the student-friendly features and pedagogy, the variety of student formats available, and the uniquely affordable pricing options, the *Introduction to Business*, 3e, also includes a number of ancillaries and supplements that instructors will find useful when teaching their courses:

- ***Test Item File***—An extensive set of multiple-choice, short-answer, and essay questions for every chapter are provided for creating original quizzes and exams.
- ***Instructor's Resource Manual***—This enhanced version of the book offers assistance in preparing lectures, identifying learning objectives, developing essay exams and assignments, and constructing course syllabi.
- ***PowerPoint Presentations***—Key points in each chapter are illustrated in a set of PowerPoint files designed to assist with instruction.
- ***Online Video Labs with Student Worksheets***—This collection of high-quality, dynamic, and sometimes humorous video segments (contemporary and classic), produced by a variety of media, academic, and entertainment sources, is accessed via the Web. Organized by chapter, the video segments illustrate key topics and issues discussed in the text. Each video segment is accompanied by a student worksheet that consists of a series of discussion questions that help students connect the themes presented in the video segment with key topics discussed in the specific chapter.

Student Supplements and Upgrades (Additional Purchase Required)

- ***Lecture Guide***—This printable lecture guide is designed for student use as an in-class resource or study tool. Note: Instructors can request the PowerPoint version of this guide, which can be used as developed or customized.
- ***Quizlet Study Set***—Quizlet is an easy-to-use online learning tool built from all the key terms in the textbook. Students can turbo-charge their studying via digital flashcards and other types of study apps, including tests and games. Students are able to listen to audio clips and create their own flashcards. Quizlet is a cross-platform application and can be used on a desktop, tablet, or smartphone.
- ***Study Guide***—The Study Guide is available online, and a printable version is available via downloadable PDF chapters for easy self-printing and review.

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Dr. Julian E. Gaspar is the director of Texas A&M University's Center for International Business Education and Research (CIBER) and is responsible for internationalizing Mays Business School's academic programs and faculty research. As the director of one of America's 15 CIBER business schools since 1991, Dr. Gaspar's mission is to infuse and promote internationalization of business courses. He is the architect of institutionalizing internationalization in Mays business curriculum through international business course design and development and through implementation of overseas study programs. Dr. Gaspar teaches international finance and conducts three study abroad program with Mays students to China, Europe, and India. He is an international economist by training, with three decades of international expertise in country risk analysis, project economic and financial analysis, and financial and industrial restructuring of emerging economies. His corporate experience stems from his years of work with Bank of America in Tokyo and San Francisco, where he conducted country risk analysis and researched and analyzed debt problems of developing countries. During his tenure as an international economist with the World Bank Group in Washington, DC, Dr. Gaspar worked on analyzing investment projects in Asia and designing financial and industrial restructuring programs for Poland and Cyprus. Dr. Gaspar received his PhD in international and monetary economics from Georgetown University, an MBA from Indiana University, and a BS in chemical engineering from the University of Madras, India. He consults with the U.S. State Department on business education reform in Central Asia and Russia, and is the lead author of two textbooks—*Introduction to Business* and *Introduction to Global Business*.

Leonard Bierman is a professor of management at Texas A&M University. He grew up in New Jersey and attended Cornell University and then the University of Pennsylvania Law School. Following law school, he did graduate work in economics at the University of California, Los Angeles as part of a fellowship in law and economics. He practiced law with two major law firms and held high-level positions at the U.S. Department of Labor, the Equal Employment Opportunity Commission, and the U.S. International Trade Commission. Professor Bierman teaches at Mays Business School and has also taught in both Italy and Russia, and has been a consultant to numerous organizations. He has been a visiting scholar at Harvard Law School in its Program on Negotiation and has been published widely in the labor relations/negotiations/international trade area. He and his wife, who works for a local religious organization, live in College Station, Texas, with their two children.

Dr. James W. Kolari is Director of the Global Commercial Banking Program at Texas A&M University. He has taught classes on financial markets and institutions, and has been active in international education, consulting, and executive education. He holds the JP Morgan Chase Professorship in Finance at Mays Business School at Texas A&M University. With over 100 articles published in refereed journals, numerous other papers and monographs, 20 co-authored books, and over 100 competitive papers presented at academic conferences, he ranks in the top 1 to 2 percent of finance scholars in the United States, according to recently published guides of research productivity among finance professors. His papers have appeared in such domestic and international journals as the

Journal of Finance; *Review of Financial Studies*; *Journal of Business*; *Review of Economics and Statistics*; *Journal of Money, Credit and Banking*; *Journal of Financial Research*; *Journal of Banking and Finance*; *Real Estate Economics*; *Journal of Economic Dynamics and Control*; and the *Scandinavian Journal of Economics*. Papers in Russian, Finnish, Dutch, Italian, and Chinese have appeared outside of the United States. Dr. Kolari has been a Fulbright Scholar at the University of Helsinki–Finland, Faculty Fellow with the Mortgage Bankers Association of America, and Visiting Scholar at the Federal Reserve Bank of Chicago, in addition to being a consultant to the U.S. Small Business Administration, American Bankers Association, Independent Bankers Association of America, and numerous other banks and organizations. He has also worked as an advisor on the North American Free Trade Agreement for the state of Texas, as a consultant for the Mexican government in financing technology, as a member of the Academy of Sciences for Higher Education in Russia, and as a Faculty Fellow at the Swedish School of Business Economics in Vaasa, Finland.

Richard T. Hise is a professor emeritus of marketing, Texas A&M University, where his teaching and research interests were and still are marketing strategy, product development and management, management of technology, international marketing, and logistics. His articles have appeared in such marketing and business publications as the *Journal of Marketing*, *Business Horizons*, *Sloan MIT Management Review*, *Journal of Global Marketing*, *Journal of Product Innovation Management*, *Research-Technology Management*, *Industrial Marketing Management*, *Journal of the Academy of Marketing Science*, *Marketing Management*, *Journal of Business Strategy*, and the *Journal of Business Case Studies*. Dr. Hise is the author or co-author of six marketing or business textbooks. A consultant to major companies (Hotel Sofitel, Lockheed Martin, Mary Kay Cosmetics, Harley Davidson, Rosewood Properties, and Fleetwood Enterprises), he has given executive development programs for Hoffman-LaRoche, Halliburton, Amoco, and the Kuwait Institute of Banking Studies. He is the founder and principal of UltiMax Consulting Co. Dr. Hise has served as the leader/instructor for study abroad courses conducted in ten Western European countries and has taught short courses in Ecuador and Kuwait and semester-long courses at the Universidad de las Americas in Puebla, Mexico, and the Grande Ecole in Tours, France. His biography is contained in *Who's Who in America*, *Who's Who in International Business Education and Research*, and *Who's Who in Finance and Business*. He has a BA degree from Gettysburg College and MBA and DBA degrees from the University of Maryland.

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Award from the Texas Society of CPAs. He was an invited speaker at a congressional hearing regarding accounting and business ethics in Washington, DC, in 2002. Dr. Smith has provided litigation consulting on legal cases regarding ethics, international accounting, International Financial Reporting Standards, auditing, intellectual property, forensic accounting, oil and gas accounting, and business valuation. He has also given numerous keynote addresses and invited speaker presentations at academic and professional meetings. He and his wife, Dr. Katherine Taken Smith, have been married 40 years and joined the faculty at Texas A&M University-Corpus Christi in 2017.

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PART 1

THE NATURE OF CONTEMPORARY BUSINESS

Why study business? You see businesses—small, medium, and large—all around you, and they affect your everyday life. Just as you make decisions every day—about how hard you are going to work, how you are going to spend your scarce time and money, and what you are going to do tomorrow to achieve your goals for the future—businesses make similar choices, but on a global scale and with a profit motive. Events that happen around the world, such as scandalous news stories about certain business executives' practices and reassuring stories about business executives who contribute to society, and the pervasiveness of technology and the Internet have direct impacts on business success or failure that touch you every day. All of these are important reasons to study business—to make you more aware of the world around you and of how business affects you as a consumer, an employee, or an employer.

In this text you will learn the fundamentals of all the major functional areas of business—management, marketing, accounting, finance, and information and supply chain management. You will come to understand how these functional areas are interrelated and how they are all affected by globalization, technology, and ethics. We hope that this text will help you decide which functional area of business you may want to major in. But if you decide that a business major is not for you, you will still gain valuable commercial insights that will help you succeed in any job you take in the future.

Part 1 sets the stage by examining the nature of contemporary business. It starts with a definition of business and goes on to explore the environmental factors that influence business. It then analyzes and studies the importance of business ethics and corporate social responsibility. Finally, it examines the vigorous world of small business and entrepreneurship.

What Is Business?

CHAPTER 1

Source: Monkey Business Images/Shutterstock.com.

Chapter Outline

Learning Objectives

After studying this chapter, you should be able to

1. Identify the three major factors that impact business today and discuss the roles of for-profit and not-for-profit organizations in an economy.
2. Summarize the evolution of business in the United States and explain the key issues that influence its outlook for the future.
3. Explain the fundamental features of the free enterprise, or capitalist, system that make it efficient and dynamic.
4. Discuss the meaning of *market structure*, and explain why most industries fall under the banner of monopolistic competition.
5. Discuss the rationale for countries wanting to choose other forms (rather than capitalism) of economic systems and explain what direction most countries are moving toward.
6. Explain how the factors of production affect the supply of goods and services in an economy.
7. Discuss how business performance is measured in a capitalist system versus a socialist system and how the objectives of for-profit businesses differ from the objectives of state-owned enterprises and of not-for-profit organizations.
8. Explain the important role consumers play in determining corporate performance and show how businesses try to identify consumer needs.
9. Discuss why and how national output is measured.
10. Evaluate the impact of the digital revolution on businesses, governments, and societies.

Silicon Valley: The Keys to Business Success

California's Silicon Valley is known for the start-up of several dynamic and extremely successful U.S. companies, especially in such fields as electric cars, electronics, semiconductors, information technology (IT), the Internet/social media, and software development. However, behind the valley's success stories are hundreds of companies that failed. It is the willingness on the part of such entrepreneurs and investors alike to take risk that has led to major business innovations with global implications. The bulk of business activities taking place in Silicon Valley (and in other similar centers within the United States and in faraway technology centers like Bangalore, Chengdu, Nanjing, Dublin, Singapore, and Tel Aviv) are based more on exploiting human knowledge skills than on manufacturing.

The origins of the Internet revolution can be traced to the invention of the World Wide Web in 1989 by British technologist Tim Berners-Lee (working for CERN, a physics research lab on the French-Swiss border). Its commercialization began in northern California's Silicon Valley. The 1990s was a period of unprecedented excitement and growth in the information technology industry, and that euphoria spread like wildfire across the globe, impacting all sectors of economies, especially in the United States, in the form of hundreds of dotcom firms. The demand for IT talent was so fierce that sign-up bonuses became a norm. To attract these skilled knowledge workers, some companies provided flexible work hours, lax dress codes, on-site health facilities, free meals or snacks, and so on, with little regard for cost control.

This new environment was so contagious that some economists and Wall Street finance gurus saw the beginning of a new era in which standard measurements of business performance such as profits, dividends, and consumer demand no longer seemed to matter. To most entrepreneurs in Silicon Valley, the future was just rosy and filled with high expectations. Ordinary citizens with some savings saw the opportunity to make money. They plowed their savings and retirement funds into these technology stocks, and thus helped to perpetuate the boom. Stock prices of many of these companies took on a momentum of their own, with share prices of companies like Yahoo.com jumping by $20 or more in a single day. Only in 2000 to 2002 did it become apparent that some of the stock analysts, as well as some corporate executives, were unethical and were misleading investors on the companies' business prospects. The collapse of dotcom share prices started in 2000, and many saw their shares trading in 2002 to 2003 at 3 percent of their peak values. Quite a few of the dotcoms vanished.

The economic implications of the collapse of dotcom shares were serious, since several of these companies participated in unethical accounting and financial practices. With the bursting of the technology bubble and the losses at supporting financial institutions, hundreds of thousands of white-collar technology workers and bankers lost their jobs, bringing the stock market down along with them. As Harvard business professor Quinn Mills points out, financial bubbles are engineered by professional players who take advantage of public excitement and ineffective government regulations to realize profit opportunities.[1] As a result of this episode, New York Attorney General Eliot Spitzer took charge in early 2002 to remove Wall Street's corporate abuses and increase investor confidence in the United States' premiere financial center. And now in 2018, a set of tech companies, the Faangs (Facebook, Amazon, Apple, Netflix, and Google), is on a roll. Time will tell if this situation is different!

LEARNING OBJECTIVE 1
Identify the three major factors that impact business today and discuss the roles of for-profit and not-for-profit organizations in an economy.

Introduction

Business is *global* in nature regardless of where you live. Also, we live in an *information technology* age, where developments—scientific, social, or commercial—in one part of the world can and will be transmitted across national boundaries instantaneously via big data networks. As illustrated in the opening story, entrepreneurs who can identify opportunities and commercialize them are bound to do well, provided they stick to some fundamental principles of business and *ethics* as discussed in Part 1 of this text. Yet, because of competition, there will always be winners and losers in business.

Defining Business and Profit

When you ask yourself the question, "What is business?" as you commute to class, the first things that you may recall are the stores and billboards that you see on your route. These may include gasoline stations such as Exxon and Shell; fast-food establishments like McDonald's and Burger King; car dealerships like Ford, Hyundai, and Toyota; airlines like American, British, and Cathay Pacific; retailing giants like Walmart and Auchan; smart phone manufacturers like Apple and Samsung; even a hairstylist or a Salvation Army store. In technical terms, these operations—big and small—are called **businesses**. There is one thing common to all these operations: They are all trying to create value for their customers.

businesses Those organizations that try to create value for the customer.

Peter Drucker, an Austrian-American and world-renowned management professor and guru, defined businesses as just that, those organizations that create value for the customer. If businesses did not create value, that is, if they did not meet a customer's unsatisfied need, they would cease to exist.

Basically, there are two types of businesses. The first type, which comprises the vast majority of businesses in the world today, exists to make a **profit**. Simply put, profit is the difference between revenue (income or sales) and expenditure (cost of goods or services sold). This means that these businesses produce goods (e.g., gasoline, burgers, cars, cell phones, and computers) or services (e.g., haircutting, laundering, banking, and connecting to the world) for a profit.

profit The difference between revenue (income or sales) and expenditure (cost of goods or services sold).

The businesses that make up the second type are called **not-for-profit organizations**. Examples are the Salvation Army, Goodwill Industries, most educational institutions, and the like. Their primary objective is to provide goods and services to society without the goal of making a profit. Some of these not-for-profit organizations may charge a nominal amount for their goods and services, but this is meant to cover basic business cost, even if some of the items are donated. While not-for-profit organizations play an extremely important role in society worldwide, we will focus more attention on "for-profit" businesses.

not-for-profit organizations Organizations whose primary objective is to provide goods and services to society without the goal of making a profit.

For-profit businesses provide a whole array of goods and services to society. Did you ever wonder why businesses are so eager to sell their goods and services? Surely, it is not to make themselves feel good. It is for profit! The more goods and services that businesses sell, the more profit they hope to make. The more profit they make, the greater is the income to the owners of these businesses. Is this fair? Sure! These businesspeople have invested their money and time and have taken a **risk** to create goods and services that they hope consumers will buy. Risk is nothing but the probability that the business will fail. When a person takes a risk by investing his or her money and time setting up a business, he or she expects to be rewarded for it. The reward, which is profit, is never guaranteed. Why? Well, it depends on the consumer. If the consumer does not see the need for the product (or service) or does not like the product for whatever reason, then the consumer will not buy it. Consumers all over the world behave in a similar fashion, although for cultural reasons they may have dissimilar tastes. If consumers do not purchase goods and services provided by businesses, profits will not be realized and businesses will cease to grow or they may even fail. Only when businesspeople see the potential to make profits will they be willing to invest their savings in these firms so that the company may grow and generate even greater profits for investors. This growth helps the whole

risk The probability that the business will fail.

Source: Rawpixel.com/Shutterstock.com.

An NGO preparing fundraising posters to support healthy living and prevention of obesity.

country, since when business grows, more people (including high school and college graduates) will be hired to take on the new jobs being generated. As employment increases, tax (federal and state income taxes, state sales tax, and property taxes) collection increases, and that will lead to more or better public services (schools, roads, and police). In addition, as employment increases, people will want to buy houses, smart phones, cars, and other necessities and luxuries of life. This in turn will boost the economy even further. That's one of the main reasons why a country's economic and financial managers and professional investors pay such close attention to corporate profits. The level and rate of growth of corporate profits are bellwethers that indicate the health of business and the economy as a whole.

✔ Reality Check

What are the major not-for-profit organizations in your community? Do you think they play an important role in the community?

The Evolution of Business in the United States

LEARNING OBJECTIVE 2

Summarize the evolution of business in the United States and explain the key issues that influence its outlook for the future.

The origin of business in the United States is fascinating and can be traced to the time when settlers from Europe crossed the Atlantic Ocean. The business climate reflected a combination of different government institutions and policies, the availability of abundant land and diverse natural resources, and a constant and growing inflow of migrants and capital, initially from Europe. All these factors helped fuel the growth of American cities and founded and developed important industries. (The evolution of U.S. business is summarized in Exhibit 1.1.)

The Industrial Revolution and the Growth of the Factory System in the United States

During the 60 years between 1815 and 1875, the Industrial Revolution, which began in Great Britain, transformed the United States from an agrarian economy into an industrial giant. Britain's Industrial Revolution had its spillover effects in such areas as railways, roads, harbors, electric power plants, and telephone and telegraph systems.[2] The United States, with its continental-sized land mass, large mineral deposits, relatively scarce but growing labor force, and individualist philosophy, offered profit-seeking businesspeople the opportunity to earn a high return on their investment. Agriculture in the United States was very profitable and led to rising farm incomes and a strong demand for standardized consumer products.

The Industrial Revolution brought with it new technologies that facilitated mass production of standardized items beneath one roof—the **factory system**. Under the factory system of mass production, raw materials, machinery, and labor were brought together in large volumes in one location to produce goods less expensively. Since production was on a large scale, raw materials and machinery could be purchased in bulk and at lower cost. However, the growing demand for mass-produced goods led to labor shortages in factories. This caused labor cost to rise, which in turn forced businesses to invent and adopt labor-saving equipment and manufacturing techniques that became a unique feature of "Yankee ingenuity." The new machines were capable of producing goods faster, cheaper, and more uniformly (and of better quality) than those produced by hand. Over time, this type of manufacturing process led to the **specialization of labor**; that is, employees were grouped together on the basis of their skills and factory demand and were increasingly assigned to specific tasks.

factory system A method of mass production in which raw materials, machinery, and labor are brought together in large volumes in one location to produce goods less expensively than in dispersed locations.

specialization of labor Grouping employees to work on assigned tasks on the basis of their specific skills and factory demand.

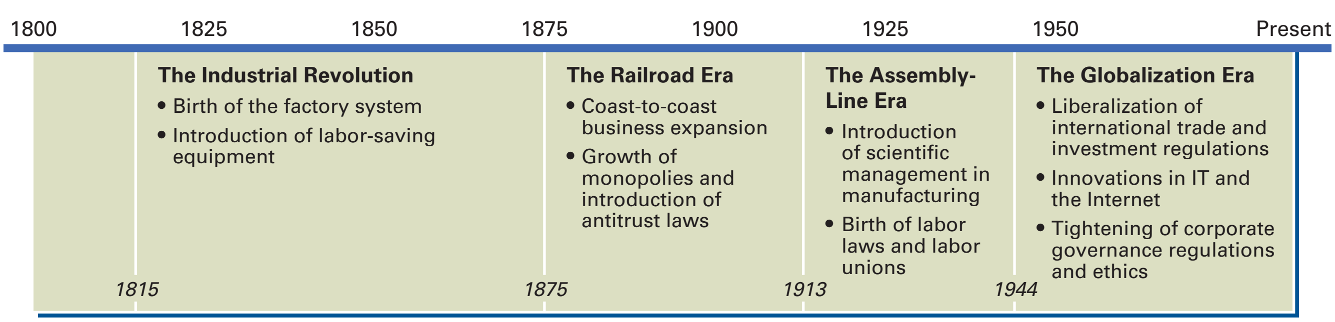


EXHIBIT 1.1 The Evolution of Business in the United States

The Railroad Era

In the early 1870s, the railroad drove economic expansion, encouraged massive speculation, and created fabulous wealth. Continental railroads turned the United States into a unified market from coast to coast. Retailers expanded to serve immigrants (including Chinese) who worked on building the railroad system. Land values soared along the rail routes, and cargo that took weeks to travel by boat and wagon could now be moved in days. The railroad era, like the dotcom era of the late 1990s and early 2000, was riddled with speculation, corruption, and miscalculation. Rail barons worked political connections to obtain federal land grants, and speculators grew rich. During this period, the advanced technologies developed by U.S. business made the United States the most important country among the industrialized nations of the world. For example, during the 1875 to 1913 period, the U.S. share of world manufacturers rose from 23 to almost 36 percent while Britain's declined from nearly 32 to only 14 percent.

This largely reflected the rapid growth of the relatively young country and the **laissez-faire** system followed by the nation at that time. The principle of laissez-faire advocates total government inaction in business; that is, businesses are free to do what and as they please. Key contributing factors to U.S. economic growth were a steady natural increase in domestic population supplemented by a large immigration (including imported slaves) inflow and a high rate of business investment. Businesses exploited the buoyant economic conditions, which supported a rising standard of living for most Americans. This period also saw one of the most rapid growths in the number and size of companies in the United States. A side effect of the laissez-faire system was that it encouraged companies to consolidate (merge) and dominate the market. **Market domination** was established through either acquiring competitors or colluding with companies that resisted acquisition. As their size grew, some of these firms became so powerful that they dominated the market by controlling product prices and preventing competitors from entering the market. Consumers as well as affected businesses protested this unregulated laissez-faire system. This ultimately led the U.S. government to institute **antitrust policies**—laws designed to break up monopolies and control monopoly abuses—in 1890 and 1914. Antitrust laws set limits on firm behavior by prohibiting certain kinds of anticompetitive practices (like price fixing, market sharing, predatory pricing, and exclusionary activities).

laissez faire The economic doctrine that advocates total government inaction in business, so businesses are free to do what and as they please.

market domination A strategy of either acquiring competitors or colluding with them to control product prices and prevent new competitors from entering the market.

antitrust policies Government laws designed to break up monopolies and control monopoly abuses by business.

The Assembly-Line Era

A new era in manufacturing began in 1913 when the Ford Motor Company started mass production of Model T cars at its Highland Park, Michigan, plant in the United States. Ford used an assembly line where the factory worker remained in one spot and the car came to the worker to be assembled. This system of production was based on studies to determine the most efficient approach to production. The idea was to avoid unnecessary movement on the part of the worker to complete a specific job. In a system that brings an incomplete car on an assembly-line track to a worker, the time and effort needed to perform a specific task is minimized as compared with a system in which the car's position is fixed and workers have to spend a lot of time moving around it. The net result was that the assembly line reduced production cost and made cars more affordable, thereby encouraging sales. The assembly line is still used in several industries today, although the techniques for using it have been further refined. The drawback of this system is the monotony that it creates for the worker and the ever-increasing pressure to perform better and faster. Assembly-line employees complained about the rigors of working under those conditions. This contributed to the formation of labor unions that strove to protect workers' rights. The government's role increasingly became one of a mediator between labor (preventing exploitation of workers) and business (preventing unreasonable demands on firms that could lead to their financial ruin).

The Post–World War II Period: The Globalization Era

Europe was physically devastated after World War II, while the U.S. infrastructure was relatively unharmed. In order to rebuild Europe, the United States instituted and paid for the Marshall Plan. In addition, several important international institutions were set up under U.S. leadership to develop new rules for facilitating international trade, foreign investment, and global economic growth. Key among these international financial institutions were the International Monetary Fund (IMF) and the World Bank, both headquartered in Washington, D.C. The IMF's role was essentially to facilitate and support stable exchange rates (of currencies) and the flow of capital (money) between countries so that countries could increasingly invest and trade with each other without being too concerned about the value of their currencies. The World Bank was set up as an international development institution whose primary role was to provide financial and technical assistance to rebuild Europe. Only countries that were members of the United Nations could choose to become members of the IMF and the World Bank. Member countries provided aid money to the World Bank for distribution to needy members on relatively easy repayment terms, while some funds were disbursed as interest-free grants. Although World Bank funds were initially geared to rebuilding Europe, rapid recovery in Europe soon led to the diversion of development funds to other poorer countries of the world.

To facilitate trade, the General Agreement on Tariffs and Trade (GATT) was established in 1947. The GATT sets rules of conduct for international trade policy and is headquartered in Geneva. Much of the multilateral tariff reduction that has taken place since World War II has been accomplished under the GATT (now renamed the World Trade Organization [WTO]). Over the years several rounds of trade policy liberalization have taken place. Each trade liberalization step has led to the accelerating **globalization** of business because tariffs were lowered further and quotas eliminated. This, in turn, gave a boost to international competition through the increased exports of goods and services, as well as capital flows between countries. Globalization is the process of integrating the market for goods and services worldwide. One could argue that the globalization of business, which began after World War II, has led to the worldwide economic and social advances that we are witnessing today.

globalization The process of integrating the market for goods and services worldwide.

The New Society of Knowledge Workers[3]

The society that we currently live in is already diverging from that of the twentieth century, which saw the rapid decline of the agricultural sector that had dominated society for thousands of years. In 1913 farm products accounted for 70 percent of world trade, whereas now their share is at most 17 percent. In the early years of the twentieth century, agriculture in most developed countries was the largest single contributor to a country's production of goods and services; now in rich countries its contribution has dwindled to the point of becoming marginal. And the farm population is down to a tiny proportion of the total.

Manufacturing has traveled a long way down the same road as well. Since World War II, manufacturing output in the developed world has tripled in volume, but inflation-adjusted manufacturing prices have fallen steadily. Manufacturing employment in the United States has fallen from 35 percent of the workforce in the 1950s to less than half that now, without causing much social disruption. However, such a transition in countries such as Japan or Germany, where manufacturing workers still make up 25 to 30 percent of the labor force, is proving difficult. Furthermore, the cost of services, especially prime knowledge products—health care and education—has tripled (even adjusted for inflation) since World War II.

While the **new economy**, an economy largely driven by developments in information technology and the Internet, may or may not materialize, one thing sure to happen is that the next successful society will comprise **knowledge workers**—people whose jobs require good formal and advanced schooling. In the developed as well as the developing countries of the world, the role that knowledge workers play, especially by using information technology (IT) tools, will be more important than information technology or the Internet itself.

new economy An economy largely driven by developments in information technology and the Internet.

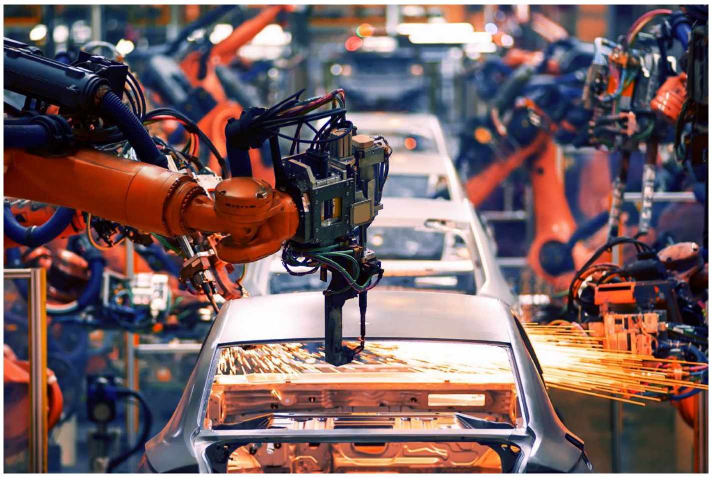
knowledge workers Employees whose jobs require formal and advanced schooling.

Knowledge will be a key resource, and knowledge workers will be the dominant group in the future workforce. The main characteristics of the knowledge workforce will be

- Borderless, because knowledge travels even more effortlessly than money
- Upwardly mobile, since knowledge will enable everyone who has acquired a good formal education to move up
- Financially successful

Together, these three characteristics will make the global society highly competitive for businesses and individuals alike. This effect is already illustrated clearly by the volume of knowledge-based services that are being outsourced to countries like India.

Information technology, although only one (the others include biotechnology and nano technology) of many features of the new society, is already having a tremendous effect: It is allowing knowledge to spread almost instantly and making it accessible to everyone. Given the ease and speed at which information travels, every institution in the knowledge society—not only businesses but also schools, universities, hospitals, and, increasingly, government agencies too—will need to become globally competitive, even though most organizations will continue to be local in their activities and in their markets. The reason is that the Internet and social media will keep customers everywhere informed about what is available and at what price anywhere in the world. This new economy will rely heavily on knowledge workers, which at present describes people with considerable theoretical knowledge and learning: doctors, engineers, scientists, and teachers. The most striking growth, however, is anticipated in knowledge technologists: computer technicians, software designers, clinical lab analysts, manufacturing technologists, and paralegals. Just as skilled manufacturing workers were the dominant social and political force in the twentieth century, knowledge technologists are likely to become the dominant social, and perhaps also political, force over the next decades.



Source: Jenson/Shutterstock.com.

A highly automated car assembly line operated by robots that do the heavy lifting and precision work designed by knowledge-intensive workers who are in the background operating artificial intelligence (AI) computer systems.

✔ Reality Check

Have you seen any changes in business activity in your hometown over the past five years? If yes, what is the cause of these changes?

Types of Economic Systems and Their Impact on Business

Economic resources (land, labor, capital, and technology) are scarce, and no matter how much we have of them, we continue to face a shortage—the inability to have as much as we want at a price that we are willing to pay. Countries have adopted different approaches to allocate these scarce resources among competing demands in order to generate economic growth and employment. The economic system adopted by any particular country depends basically on the following factors.

These factors have a profound effect on the efficiency of resource allocation, business development, economic evolution, and growth. The country with the most open (ease of entry into and exit out of industry) type of economic system will tend to have the most efficient system of resource allocation and rapid business growth.

- Ownership of the factors of production (private versus government)
- Method of resource allocation
- Transparency of economic policies
- Availability of functioning institutions

economic resources Land, labor, capital, and technology that are scarce.

The Free Enterprise, or Capitalist, System

LEARNING OBJECTIVE 3
Explain the fundamental features of the free enterprise, or capitalist, system that make it efficient and dynamic.

capitalism The economic system that is based on private property rights, the free market system, the pursuit of self-interest, the freedom to choose, and the ability to borrow money.

free market system The economic system in which consumers demand certain goods and services and are willing to pay a price based on their budget, and producers are willing to supply the goods and services on the basis of a price that will cover their costs and provide a profit margin.

The economic system practiced in the United States is largely **capitalism** (also called the free enterprise or free market system), which is based on private property rights, a free market system, the pursuit of self-interest (profit or wealth maximization), the freedom to choose, and the ability to borrow money. Far from the popular image of a haven for "corporate fat cats," a capitalist economy crowns the consumer as king, and the system provides for the public's well-being.[4]

In the free enterprise system, the key players are consumers and producers. Consumers like you and me are in the market to buy all sorts of goods (books, clothes, toiletries, food, smart phones, etc.) and services (airline tickets, concert tickets, season passes for ball games, etc.). Some of these goods and services that we purchase may be imported (e.g., Heineken beer from Holland or a Singapore Airlines ticket). In the **free market system**, consumers demand certain products or services and are willing to pay a certain price for them based on their usefulness and the consumers' budget. The producer, on the other hand, is willing to supply the goods or services to the consumer at some price, which will depend on the cost of the inputs used in producing the goods or services and a profit margin. The United States is the largest economy in the world, followed closely by China, and essentially practices a free market system. Most European countries, as well as other developed countries and regions like Japan, South Korea, Taiwan, Singapore, Hong Kong (now a Special Administrative Region of China), Chile, and so on, essentially follow the free enterprise system. The relationship between the economic system and business is very close, and unless you understand how a particular economic system works, you may not be able to conduct business in that country successfully. This section explains the fundamentals of the free market system, which show how private investors identify opportunities for profits on the basis of a simple demand and supply analysis and the degree of competition in a market.

Demand, Supply, and Price

Consumers create a *demand* for goods and services, and the quantity demanded depends on the price of the product or service, as well as on how much money the consumer has at her or his disposal. Literally, there are hundreds of goods and services that people consume to maintain their lifestyle. When they consume any one of these goods and services, they create a separate demand for each product and service. As a general rule, you will have noticed that when the price of a particular product or service falls, you tend to purchase more of it. This is the idea behind the "special sale" advertisements promoted in newspapers, on TV, and on the radio. Businesses know that when they lower prices, consumers will tend to demand (purchase) more of their product. This behavior has led to what is called the **theory** or **law of demand**: Consumers will buy more when prices fall and less when prices rise. Just imagine what you would do if the price of gasoline were doubled. You would at once try to carpool with your friends to school or work and cut down on your cruising habits too! What you are essentially doing is reducing your demand for gasoline. Just remember, you are not the only one who will cut down on gasoline consumption when prices rise. Your friends and neighbors will do the same as well. In fact, the whole society will do the same thing, and the net impact will be a drop in the demand for gasoline in the whole country. The opposite happens when the price of gasoline goes down. Lower gasoline prices encourage consumption and increase gasoline demand. We can represent this behavior with the help of a diagram.

theory or law of demand The statement, which appears to hold, that consumers will buy more when prices fall and less when prices increase.

Exhibit 1.2(a) shows that when the price of gasoline drops, say, from \$2.00 to \$1.50 per gallon, the quantity of gasoline demanded by a particular consumer increases from 5 to 8 gallons per week. Or, if the price of gasoline increases from \$1.50 to \$2.00 per gallon, the amount of gasoline that a consumer would purchase decreases from 8 to 5 gallons per week. The line *AB* is called the **demand curve**, which shows the relationship between the quantity of gasoline demanded and the price of gasoline for a particular customer. If there were, say, 10,000 students on campus, we could derive the demand curve for each student

demand curve The curve that shows the relationship between the quantity demanded and the price of a product or service for a particular customer, group of consumers, or even a whole country. (It is downward sloping.)

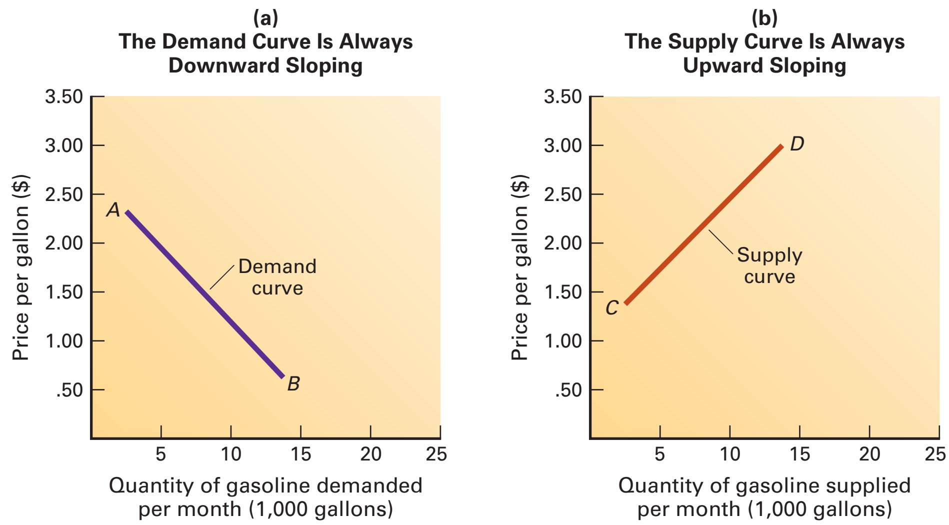


EXHIBIT 1.2 The Demand and Supply Curves

in a similar fashion. We could then aggregate (total) all the individual demand curves and determine the total number of gallons of gasoline that the 10,000 students would demand at different prices. In a similar manner, we could determine the demand curve for any product or service for the whole city or country. It's that simple. The slope (steepness) of the demand curve is heavily influenced by the consumer's budget for that product or service and by the consumer's taste (spending priority). When the slope of the demand curve is steep, economists characterize the demand represented as **price inelastic demand**. For example, a significant increase in the price of cigarettes will have little effect on the quantity of cigarettes demanded. On the other hand, when the slope of the demand curve is very gentle, then the demand represented is **price elastic demand**. For example, a relatively small change in the price of DVDs will have a significant impact on the quantity demanded. In the real world, some products and services, like medical services, are price inelastic. When you get sick and need to see a physician, you are not likely to think twice about the high cost of doctor fees! However, if the price of Levi jeans goes up sharply, you probably will be able to get by without purchasing a new pair of jeans for some time. The demand for jeans is price elastic.

price inelastic demand The demand where significant increases in the price of a product or service will have little effect on the quantity of the product or service demanded.

price elastic demand The demand where a small change in the price will have a significant impact on the quantity demanded of a product or service.

Just as the consumer creates the demand for goods and services, the *supply* of goods and services comes from producers. Producers are willing to supply goods and services at a price that will cover their production costs and generate a reasonable profit. The higher the price, the more goods and services the producer is willing to supply. As prices go up, producers see the opportunity to make greater profits and are therefore willing to supply more goods and services. This behavior on the part of producers is generalized in the **theory** or **law of supply**: Producers will be willing to sell more when prices rise and less when prices fall. In the gasoline case that we just discussed, if the price of gasoline doubled, gas stations would be willing to sell more gasoline so that they could earn greater profits. Low gasoline prices would discourage gas stations from selling gasoline and instead encourage them to sell more items from the convenience stores that are generally attached to the gas stations these days. The producer's behavior can also be explained with the help of the same diagram.

theory or law of supply The statement, which appears to hold, that producers will be willing to sell more when prices rise and less when prices fall.

Exhibit 1.2(b) shows what happens when the price of gasoline rises, say, from $1.50 to $2.00 per gallon. The quantity of gasoline that your local gas station will be willing to supply may increase from 5000 to 7000 gallons per month. The upward-sloping **supply curve** *CD* clearly shows that as prices rise, the producer is willing to sell more of the product (gasoline in our case). Again, the steepness of the supply curve carries important meaning. If the supply curve is steep, the implication is that large changes in the price will have little impact on the quantity of goods supplied by the producer. For example, electricity has a **price inelastic supply**. On the other hand, when the supply curve slopes

supply curve The curve that shows the relationship between the quantity supplied and the price of a product or service. (It is upward sloping.)

price inelastic supply The supply where a large change in the price will have little impact on the quantity of a good or service supplied by the producer.

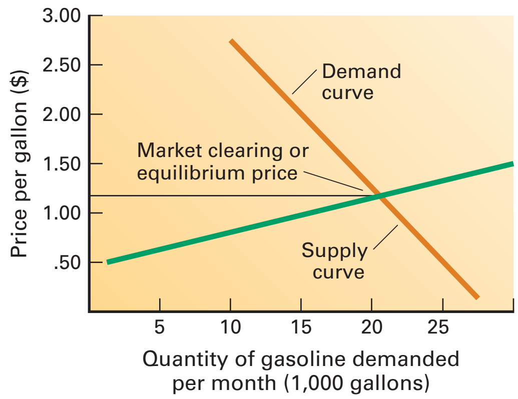


EXHIBIT 1.3 Market Clearing Price and Quantity

gently upward, a relatively small increase in price will bring about significant increases in supply. For example, a product like beef has a **price elastic supply**. One point to remember is that the producer does not just supply one consumer but a whole bunch of consumers in a given market or region. Also, there may be several producers for a single product, in which case an aggregate (total) supply curve can be developed. The aggregate supply curve is also called the market supply curve.

price elastic supply The supply where a small change in the price will bring about significant increases in the quantity of a product or service supplied by the producer.

In countries that follow the free market system, the prices that consumers pay for goods and services are determined by the collective interaction of total consumer demand and cumulative producer supply. The intersection of the market demand and supply curves provides us with the **market clearing**, or **equilibrium**, **price**, the price at which supply will equal demand and there will be no unsold goods or services. This situation can also be shown with the help of a diagram.

market clearing, or equilibrium, price The price at which supply will equal demand.

In a free market system, price will always tend to move toward the equilibrium price so that the market clears—that is, everything that is produced is sold. From Exhibit 1.3 it is clear that if price falls below the equilibrium level, the quantity demanded (represented by the demand curve) will be greater than the quantity supplied by producers (represented by the supply curve). When price is such that demand exceeds supply, then we have a **shortage**. When there is a shortage, price will keep rising, so demand will shrink, and the shortage will become smaller and smaller until it vanishes. You will notice that the shortage vanishes when the price reaches the equilibrium or market clearing price. In the opposite case, when market supply exceeds market demand, we have a **surplus**.

shortage The amount of a good or service that will not be available when the price of the good or service is set below the equilibrium price. (Demand will exceed supply.)

surplus The amount of a good or service that will not be sold when the price of the good or service is set above the equilibrium price. (Supply will exceed demand.)

Private Property and Property Rights

Capitalism has been defined as that form of private property economy in which innovations are carried out with the help of borrowed money.[5] Capitalism is a system based on private property, which does not just imply land but also includes all types of personal property that you see, such as your house, car, furniture, books, stereos, CDs, and so on. In the capitalist system, along with private property comes property rights, that is, your rights to buy, own, use, and sell your property as you see fit. Private property and property rights are things that Americans take for granted. However, in communist countries like China (where property rights are changing very slowly) or in countries that have very recently gained independence from the former Soviet Union (like Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan in Central Asia), private property, especially land title, still belongs to the state (the land may be leased for 70 years or so), and there are severe restrictions on what citizens in these countries can do with their land (the house that they build on the land may belong to them, but not the land!). This lack of property rights severely restricts innovation and business, since people do not have the freedom of choice to do what they want and make a profit. There is little or no incentive to invest in property when people know that the government may take away their land at any time (or when the land lease expires). Private property rights are crucial for success in a free market system.

✔ Reality Check

How has the price of a typical laptop performed over the past three years? Why?

Degrees of Competition

LEARNING OBJECTIVE 4
Discuss the meaning of *market structure*, and explain why most industries fall under the banner of monopolistic competition.

What is competition, and why does it matter? By the time you finish reading this section, you will begin to appreciate the importance of competition, especially as it relates to the price, quantity, and quality of the products and services that are produced and consumed in an economy. Most firms are established to satisfy consumers' unfulfilled needs and, in so doing, to earn profit before the product or service they are selling becomes obsolete. All firms have a life cycle that begins with the introduction of a new, better, or cheaper product. At this stage, firms tend to be most profitable before competitors have had the time to enter the market with a cheaper, better alternative. The potential for profit motivates new entrants into the marketplace, and as the number of firms providing similar goods and services increases, the level of competition intensifies and prices fall. Unless the original firm increases its efficiency (by cutting production costs and "doing things right") and effectiveness (by introducing new products, markets, and business models, i.e., "doing the right things"), it will become less profitable, then obsolete and fade away. That is the fundamental reason why firms that do not change with time do not exist forever. Just as perceived profits attract business, in the **product life cycle**, competition forces firms to become efficient, invest, and outsource products and services abroad or to go out of business. In the capitalist system, the law of the corporate jungle is clear: compete—restructure—or die. This is called the process of "creative destruction." The degree of competition that firms face can vary from industry to industry and from country to country.

product life cycle The theory that explains the different stages—introduction, growth, maturity, and decline—that a product goes through before it fades away.

Market structure is the term that economists generally use to describe the level of competition within an industry. The amount of competition that firms face is determined by the number of firms that operate in that particular industry, the ease of entry into that industry, product homogeneity, and the supplier's control over price. At one end of the industrial spectrum we have agriculture, where there are literally hundreds of thousands of suppliers who produce essentially identical products (e.g., milk, beef, chicken) that are sold at a price determined by the market. Such a system is called **pure competition**, and it must meet the following market conditions:

market structure The organization of an industry determined by the level of competition within the industry.

pure competition The industry market structure in which a large number of suppliers produce essentially identical products, which are sold at a price determined by the market.

1. The number of firms in the industry must be large, and none must be so big as to have undue influence on the price of the product or service that is being sold.
2. Entry into and exit out of this industry must be relatively easy so that firms can get in and out of this business if they so desire.
3. Each firm must produce a product or service identical to that of the other firms so that consumers cannot differentiate between the products.
4. The price for the product must be determined by the overall market demand and supply, and neither a single supplier nor a single customer must be able to influence prices.

At the other extreme, one could witness a utility (electricity) company that services a large region of a country all by itself. In this case we would have a **monopoly**, that is, a single firm supplying electricity to a large area of customers. This company then behaves like a monopolist (derived from the Greek words *mono* for "one" and *polist* for "seller"). Since this electric utility is the only game in town with no close substitutes for its service, it will be inclined to set prices as high as the market will bear. That is why we have utilities regulated by the government: to make sure that these firms do not make excessive profits, often called monopoly profits. On the basis of the four criteria indicated above, you will notice that entry into and exit out of the utility industry is neither easy nor inexpensive.

monopoly The industry market structure in which there is essentially a single supplier of goods or services that has the power to set prices.

Not all industries are identical in their configuration. In fact, the real world contains a significant mixture of monopoly imperfections along with elements of competition. We can then classify the real world for the most part as having the market structure of **imperfect competition**, one that is neither perfectly competitive nor perfectly monopolistic. Imperfect competition arises when the total industry's output of goods or services is supplied by a small number of firms at market-determined prices. This leads to a consideration of **firm concentration ratios**, the percentage of the total industry output that

imperfect competition The industry market structure where the industry's output of goods or services is supplied by a relatively small number of firms and price is largely determined by market forces.

firm concentration ratios The percentage of total industry output that can be accounted for by the four largest firms and so a measure of the sellers' market power.

is accounted for by the largest firms. Normally, four-firm concentration ratios, defined as the percentage of total industry output that is accounted for by the four largest firms in the industry, are used to measure the monopolistic nature of an industry. In 2007, about 15 percent of total food manufacturing in the United States was accounted for by the four largest companies.[6]

The differences in market structure arise from variations in cost composition between industries as well as from barriers to competition. In some industries, production will need to be on a large scale in order to make economic sense. Take, for example, the automobile industry. Given the huge investment in plant and equipment that will be needed, the thousands of parts required to assemble a car, the spare parts inventory, and the personnel that will be required to manage and operate the plant, average production cost will continue to decline as the number of cars produced increases. Hence, there are significant economies of scale in automobile production that could essentially wipe out small-volume car producers that will invariably have higher average costs. Unless the market for cars is large, it will not make sense nor will it be profitable to build mini auto plants. That's a major reason why you don't see automobile plants in countries with a small car market. It would make more sense to import cars than to build them in these countries.

barriers to competition Barriers that arise when certain legal restrictions (patent protection, licensing, and tariffs) that reduce the level of competition are imposed on an industry.

patents Awards to companies or individuals by governments to protect their inventions (intellectual property) by providing exclusive rights to the owner to produce the goods (e.g., pharmaceutical products) or services (e.g., software or operating systems) for a set period of time, thereby preventing others from doing so during that time period.

licensing The practice by governments of selecting investors to operate certain types of businesses, thereby restricting entry into those businesses and reducing competition.

tariffs Taxes on imports that raise the price of imports and consequently enable domestic competitors to raise prices as well.

oligopoly The industry market structure where a few producers of almost identical products cater to the needs of the whole market.

product differentiation A strategy that firms employ to make their product seem different from those of their competitors.

Barriers to competition, also sometimes called barriers to entry, arise when certain legal restrictions are imposed on an industry or when suppliers themselves try to differentiate their products or services. Examples of legal restrictions to competition include patent protection, licensing, and tariffs. **Patents** are awarded to companies or individuals by governments to protect their inventions (intellectual property). Patents provide exclusive rights to the owner to produce goods (e.g., pharmaceuticals) or services (e.g., software) for a set period of time, thereby preventing others from doing so during that period. A patent awards exclusivity, or monopoly rights, to the owner for a given period of time so that the inventor can recoup the research and development cost of the invention and also earn a certain profit for the effort. **Licensing** operates in a similar manner and is more prevalent in developing countries where governments select certain investors to operate a particular type of businesses (cement manufacturing, steel production, etc.). Licensing restricts entry into an industry, thereby reducing competition. Finally, **tariffs**, which are taxes on imports, raise the price of imports and boost prices to domestic consumers. Domestic producers of import-competing products are therefore provided relief from overseas competition (from lower-cost imports).

Oligopoly How imperfect can imperfect competition get? At one extreme is the monopolist, or single seller. **Oligopoly** implies "few sellers," that is, an industry in which a few sellers cater to the needs of the whole market. An oligopolist is one of these few sellers who produces and sells identical (or almost identical) products like cement, steel, copper, and so on, or services like airlines. On the basis of the four conditions of market structure that were discussed earlier, you will find that oligopolists are generally large producers, so only a few of them are needed to supply the whole market. Since the products or services sold by oligopolists are quite similar, when an oligopolist lowers prices, consumers will at once switch to the lower-price seller. In order not to lose market share, the other oligopolists will be forced to match the lower prices or go out of business. If you use commercial airlines, you will understand what we mean. For example, if American Airlines lowers its fare between any two cities, other carriers that cater to that pair of cities will lower their prices as well and will match American's fare; otherwise, customers will flock to American Airlines. Unlike a monopolist, the oligopolist does not control prices, but each can have a great effect on market price, especially downward.

Monopolistic Competition The key characteristic of monopolistic competition is **product differentiation**. Although there are quite a few sellers in this type of market structure, each firm will try to make its product sound or appear different from the rest. Although the number of producers remains large (not as large as in pure competition), each firm will try to advertise and promote its products as if they are unique. Take, for example, jeans, which are a common product. However, through the creation of brand awareness,

EXHIBIT 1.4 Market Structure

Most industries fall in the category of monopolistic competition.

	Pure Competition	Monopolistic Competition	Oligopoly	Monopoly
Where prevalent	Agricultural products, e.g., corn, rice, wheat	Retail trade, e.g., fast food, gasoline	Airlines, autos, construction materials, e.g., cement, steel	Utilities, e.g., cable TV, telephone, electricity
Number of producers	Numerous	Many but not as numerous	Few	Single producer
Product differentiation	Identical products	Perceived differences in product	Some difference in product	Unique product with no close substitutes
Barriers to entry	None	Relatively easy	Relatively difficult	Regulated by government
Degree of control over price	None	Some	Some	Considerable
Methods of market promotion	Minimal promotion	Heavy advertising to differentiate product	Advertise heavily to promote perceived quality	Advertise service, quality, and reliability

brands like Polo, Calvin Klein, Levi's, Wrangler, Lee's, Rustler, and so on, the companies try to give the consumer the impression that their jeans are something out of the ordinary—in a class by themselves. Each company tries to convey to the consumer that its jeans are unique—one of a kind—in the market, and it wants to behave like a monopolist in the market for its jeans. This way it can try to charge a monopoly price. While some consumers may say that jeans are jeans and go for the ones that cost the least, there are others who are convinced that "there is nothing between me and my Calvins" and are willing to pay a high price for a pair of Calvin Klein jeans.

Since product differentiation is such an important part of monopolistic competition, firms in this industry spend a tremendous amount of money on advertising to convince the consumer that their product is truly different. Other industry examples of differentiated products include perfumes, soda pop, toothpaste, detergents, makeup, sneakers, gasoline, and so on. While the utility value of all the products within a category may be about the same, the aura of the specific product enables the supplier to charge a higher price and reap some monopoly profit.

Exhibit 1.4 summarizes the basics of market structure in a capitalist system. The degree of competition varies from pure competition with numerous sellers of identical products, to a large number of sellers of differentiated products, to a system of few sellers of almost identical products, to the limiting case of a single seller—a monopolist. Each structure is associated with a particular pricing mechanism, which is of significant importance to businesses and consumers.

✔ Reality Check

How has the price of a typical laptop performed over the past three years? Why?

LEARNING OBJECTIVE 5

Discuss the rationale for countries wanting to choose other forms (rather than capitalism) of economic systems and explain what direction most countries are moving toward.

The Command, or Planned, Economic System

Capitalism is a system based on profits and efficient resource allocation, along with the primary goal of satisfying consumer demand. At the other end of the spectrum of global economic systems is the **command**, or **planned**, **economic system**, in which ownership and control of all the factors of production are totally in the hands of the government and

command, or planned, economic system The economic system in which the ownership and control of the factors of production are totally in government hands.

not the private citizens. The concept of private property does not exist in this system, and the government makes all decisions on which goods and services will be produced, where they will be produced, how much of those goods and services will be produced, and at what price they will be sold. As you can see, the consumer has little say in such a system. In the command economic system, the government plans (hence it is sometimes called the planned economic system) production on the basis of national goals and an elaborate analysis of sources and uses of resources available to the economy. The government's objectives are to

- Utilize as much of domestic resources as possible, since these countries invariably focus on domestic self-sufficiency and not on international trade
- Employ whoever is willing to work in order to solve unemployment and poverty
- Minimize income inequality among workers by diminishing wage differentials
- Provide limited choice to workers in terms of where to work and what type of work they can undertake

The command economic system is based on the assumptions that the government knows what is best for the consumer and the country and that it should try to eliminate wasteful conspicuous consumption. The consumer certainly is not the king in the command economic system. While the command economic system seeks to minimize the exploitation of workers, it does so at a great expense to efficiency and consumer choice (e.g., in the former Soviet bloc countries and in present-day Cuba and North Korea). In the long run, countries that follow the command economic system invariably end up bankrupt. The market mechanism is not allowed to operate, and there are no incentives for earning profits. In general, a curious thing to notice in command economies is the almost total lack of quality consumer goods. When goods are available, there is not much of a choice, and the goods are of poor quality. If a product happens to be appealing to consumers, it will invariably be in short supply, since prices are not based on supply and demand—the government sets them! Furthermore, the concepts of competition and private property do not exist. All of these elements contribute to the production of a whole bunch of goods that consumers do not want and also lead to an acute scarcity of other goods that consumers really do want.

state enterprises Government-owned firms that produce goods and services, generally in command and mixed economic systems.

Firms that produce goods and services in a command economic system are run by the government and are called **state enterprises**. State enterprises are essentially inefficient bureaucracies that employ far more workers than needed for efficient production. Prior to 1978, when China was a command economy, most Chinese consumers wore gray drab outfits and had little to look forward to in terms of consumer goods and choices. With the introduction of a free enterprise system in China in 1978 and the nascent reform of state enterprises, China is gradually becoming a relatively capitalist country with communist roots.

The Mixed Economic System

Very few economies in the world practice pure capitalism. Hong Kong, now a Special Administrative Region of China, is closest to a pure capitalist system. However, even in Hong Kong, several types of services, such as mass transportation and utilities, are still provided by the government. A number of services (defense, social services, Amtrak, the Tennessee Valley Authority, etc.) in the United States are also provided by the government. The American Credit Crisis of 2008, which was followed by the U.S. taxpayer bailout of several major private financial and corporate institutions, has enabled the United States to become less capitalistic. Most economies are mixed economic systems.

mixed economic system The economic system that exhibits elements of both the capitalist and the command economic systems.

A **mixed economic system** is one that exhibits elements of both the capitalist system and the command system. Not all services (e.g., defense and social welfare) can be provided by the private sector; hence the government plays a crucial role in providing these services, while at the same time procuring goods (fighter aircrafts, naval fleet, ammunition, etc.) from private companies. Not all mixed economies are alike. In some countries, public sector (government-owned or state-owned) enterprises play a much larger role than in others. In the industrialized countries of Europe—for example, France—the government owns (now partially) several companies like Air France and SNCF (the French railroad system). In many developing countries—for example, China and India—several companies in the manufacturing and service (banking) sectors are owned by their governments. The Chinese and Indian governments own several steel, fertilizer, petrochemical, oil and gas, machinery, and electronics firms, as well as services like airlines, railways, and shipping.

The larger the role state enterprises play in an economy, the greater the prospect for economic inefficiency. State enterprises are inherently overstaffed with underperforming employees who have little motivation to work hard or efficiently, since their salaries are generally not tied to productivity. All employees get paid more or less the same, and salaries are normally based on seniority—number of years of service with the state agency. If you have traveled to France or India, you will readily see for yourself how the United States compares with them in terms of efficiency in the production of goods and services. Countries that are dominated by private sector enterprises generally exhibit dynamic business and economic growth. The trend these days in mixed economies like France and India is to move away from state enterprises to private businesses. This is being achieved through the sale of state enterprises to private entrepreneurs—a process called **privatization**.

privatization The process of selling state enterprises to private entrepreneurs.

As countries privatize state enterprises, their economies are bound to grow faster, and productive employees will become richer. Governments can then focus their attention on providing services like social welfare and defense that generally cannot be provided by private firms. While the mixed economy is bound to stay with us for a very long time, the role of government in running businesses is destined to diminish.

The Transition Economies

In 1989, after years of state control of all productive assets in the Soviet bloc, the Berlin Wall fell and the Soviet Union broke up into several independent countries. This led to the start of market-oriented reforms in Russia and the former communist economies of Central and Eastern Europe and Central Asia. This move, from central planning to capitalism (in the direction of competitive, market-oriented, open trade economics), is called **economic transition** and is aimed at ending the inefficiencies of central planning. Privatizing state-owned enterprises is also designed to free resources and talent that can be used productively by the private sector, thereby raising the living standards of these people. While economists generally refer to the former Soviet Union countries as transition economies, China in 1978 was the first major economy to embark on the reform from state control to capitalism. China is gradually implementing market-oriented reforms that are introducing profit incentives to rural enterprises and private businesses, liberalizing foreign trade and investment regulations, relaxing state control over some prices, and investing in industrial infrastructure and the education and retraining of its workforce. By encouraging the growth of rural enterprises and not focusing exclusively on the urban industrial sector, China has successfully moved millions of workers off farms and into factories without creating a significant urban crisis. Finally, China's relatively open-door policy has spurred massive foreign direct investment in the country, creating new jobs and linking the Chinese economy with international markets.[7]

economic transition The move from a command economic system to a capitalist economic system (in the direction of competitive, market-oriented economics) that is aimed at ending the inefficiencies of central planning.

The experience of transition economies (China and the former Soviet Union countries) clearly shows the important link between private sector development and economic growth, and the fact that privatized enterprises invariably outperform state-run companies. Research on transition economies shows that firms that started from scratch with new management performed best, followed by newly privatized firms run by outsiders, either local or foreign. Privatized firms managed by insiders were found to be least efficient and productive, but even these firms did better than state enterprises. If transition economies are to grow and develop rapidly, they must ensure that the proper economic environment—institutions that support property rights, the rule of law, a competitive market structure and prices, and attention to consumer demand—is in place.[8]

✔ Reality Check

Are you aware of any government-operated business in your city or state?

Production of Goods and Services

LEARNING OBJECTIVE 6
Explain how the factors of production affect the supply of goods and services in an economy.

outputs A wide array of useful goods or services that are either consumed or used for further production in business.

inputs Factors of production (land, labor, capital, and technology), that is, commodities or services that are used by firms in their production processes.

entrepreneurs People with initiative who seize opportunities as they see them to get things done or make things happen, generally for profit.

capital goods Finished goods like machinery and equipment that can be used as inputs for further production of goods and services.

The performance of the U.S. economy is primarily measured in terms of how efficiently goods and services are produced in the country. These goods, such as cars, gasoline, TVs, computers, breakfast cereals, and so on, as well as services like haircutting, dry cleaning, banking, consulting, and transportation, are all called **outputs**. In other words, outputs consist of a wide array of useful goods or services that are either consumed or used for further production. The primary role of businesses, regardless of in which country they are located, is to produce goods or services that consumers need.

Every output requires two or more **inputs**. Economists define inputs as factors of production, that is, commodities or services that are used by firms in their production processes. The final result of the production process is outputs. For example, when we consume French fries, the potatoes, the oil, the frying pot, the oven heat, and the chef's time are all inputs. The crisp fries are the output. Traditionally, factors of production have been divided into four major categories: land (and the natural resources beneath it), labor (of all types), capital (money and capital goods like machinery), and technology.

Land consists of the ground used for agriculture or under factories or railroads (or airports, automobile roads, etc.); natural resources include nonrenewable resources like coal, crude oil, and iron ore and renewable resources like trees used in the production of lumber and paper. Nonrenewable natural resources are provided by nature and are in fixed supply.

Labor consists of human time spent in productive activities, for example, running a farm, working in an automobile factory, teaching, conducting research, consulting, or running a business. Today's economic environment has led to tremendous specialization of labor. We have engineers and scientists in various disciplines who constantly work on enhancing and inventing new technologies that can be used for improving business processes. We have **entrepreneurs**, people with initiative who seize opportunities as they see them to get things done or make things happen for a profit. While an entrepreneur does not invent things, he or she exploits in novel ways what has already been invented and brings into existence new products or services or a new business or industry. Entrepreneurs are a class of specialized labor not unlike engineers and scientists. Pierre Omidyar changed the face of Internet commerce in 1995 when he created eBay, **www.ebay.com**, the world's first online marketplace. Looking for a way to create an efficient market, he pioneered the auction format for online person-to-person trading. Entrepreneurs, as you can see, play an important role in business creation and development. Jack Ma (of China's) Alibaba has perfected the eBay concept to become the world's largest online marketplace. Other notable entrepreneurs include Jeff Bezos (Amazon), Elon Musk (Tesla and SpaceX), Mark Zuckerberg (Facebook), Steve Jobs (Apple), and Sundar Pichai (Google). The supply of human resources is generally not a response to economic conditions, but is determined by social and biological factors. Land and labor are generally called *primary* factors of production because their supplies are not determined by the economic system; that is, neither land nor labor is regarded as an output in the business sense.


Source: Lee Torrens/Shutterstock.com.

Silicon Valley (California) entrepreneurs working on developing new apps for smart phones.

Capital comes in two major forms. First, money (also called financial capital) is utilized to start businesses and run operations (paying salaries and buying raw materials). Sources of money for entrepreneurs are their personal savings, loans from banks, and the issuance of bonds (IOUs) and stocks. A second, equally important type of capital (called **capital goods** or physical capital) consists of durable goods produced by the economy in order to produce yet other goods. These durable goods include machinery, construction equipment, trucks, factories, computers, software, and so on, that you see every day. Unlike land and labor, which are primary factors of production, capital goods are produced goods that can be used as inputs for the further production of more goods and services.

Technology makes the production process more efficient through the introduction of better and cheaper ways of getting things done (providing goods and services). The information technology (IT) industry, for example, utilizes fiber-optic cables or wireless telephone and broadband networks to relay data, information, and audio and video messages within companies and across national boundaries instantaneously. Developments in information technology and the Internet are something unique. They are like the birth of electricity, the railroad, the telephone, and the telegraph years ago, each of which brought about massive changes in business and economic growth. These marvelous developments are constantly being used by business to improve production and supply chain management. Companies like SAP in Germany and Oracle in the United States are world-famous suppliers of software that helps improve planning, production efficiency, and inventory control, thereby bringing down the cost of the final output to the customer.

✔ Reality Check

What factor of production is most abundant in your state? Explain in detail.

Measuring Business Performance

LEARNING OBJECTIVE 7

Discuss how business performance is measured in a capitalist system versus a socialist system and how the objectives of for-profit businesses differ from the objectives of state-owned enterprises and of not-for-profit organizations.

In the free market system, businesses exist to meet specific consumer needs (either for products or services). In other words, businesses must provide value to the customers. In this process, businesses must be profitable to survive. The exception is not-for-profit organizations like the Public Broadcasting System, **www.pbs.org**, or National Public Radio, **www.npr.org**, whose objectives are to provide balanced reporting and educate people. These and similar not-for-profit organizations depend on contributions from "viewers like you" and on some government and corporate support. In the private sector of the United States as well as most industrialized and industrializing countries of the world, firms are owned either by individuals (like small businesses) or by major investors who have put in a lot of their own money, as well as by people like you and me who have bought company stock. All **investors** who have a financial stake in a business, be it small or large, expect to receive a return on their invested capital; otherwise, they might as well put their money in a bank and earn a small but decent amount of interest. So, how would you as an investor figure out whether you would be better off keeping your money in a bank or investing your savings in a company? To answer this, we need to analyze business performance, which is the subject of discussion in this section. We briefly look into how business performance is narrowly defined and measured and how not-for-profit organizations and different societies evaluate business performance.

investors Those who have a financial stake in a business, small or large, and expect to receive a return on their invested capital.

Maximizing Profit and Shareholder Wealth

All firms, small or big, need to make a profit to remain in business. Profit is the difference between revenue (sales of goods or services) and the cost of the goods or services sold. **Revenue** is the sum of the quantities of all goods and services sold times their price.

revenue The sum of the quantities of all goods or services sold times their price.

$$\text{Revenue} = (\text{quantities of all goods sold}) \times (\text{their price}) + (\text{quantities of all services sold}) \times (\text{their price})$$

Thus, the revenue generated by a McDonald's outlet is the sum of the quantities of all the items that McDonald's sells (Big Macs, Chicken McNuggets, French fries, cola, etc.) times their price (the price of the Big Mac, Chicken McNuggets, French fries, cola, etc.). The cost to the McDonald's outlet includes what the owner of the outlet pays for the various inputs, that is, the buns, burgers, chicken, frozen fries, cooking oil, cola, and so on. In addition, the outlet's cost includes the salaries and benefits paid to its employees, the maintenance cost of the outlet, the rent for space, and the fee (called the franchise fee) paid to McDonald's Corporation for using the McDonald's brand name and the services that McDonald's Corporation provides to the owner of the outlet. When you add up all these costs and subtract the sum from the revenue, you can determine the profit for the

Revenue				
Cost of inputs	Wages paid	Rental expenses	Franchise fee	Profit

EXHIBIT 1.5 Relationship between Revenue, Expenses, and Profit

McDonald's outlet (see Exhibit 1.5). So, if you were considering owning a McDonald's outlet, you could figure out on the basis of the anticipated profit to be generated by the outlet whether you would be better off investing your money in the business or keeping your savings in a bank. Most rational investors who start a business want to generate as much revenue as possible and at the *same time* want to keep expenses under control. That is, investors want to maximize revenue and minimize expenses. Since profit is the difference between revenue and expenses, what investors want to do is to *maximize profit*. When revenue is less than costs, the firm incurs a loss.

In large corporations like Ford Motor Company, even the Ford family is unable to come up with the huge investment (for building factories, installing various equipment, maintaining stocks of steel, etc.) needed to run the company. Although Ford may be able to borrow some money from banks to meet the expenses associated with building automobiles, trucks, and so on, banks will lend only a certain amount of money. So the rest of the funds will have to come from investors (people with savings) who will purchase stocks issued by Ford Motor Company. While Ford will not be able to guarantee a return (income, or dividends) to investors (called stockholders) on its stocks, Ford's management will try to maximize profit. Part of the profit will be distributed to Ford's stockholders in the form of **dividends**. Thus, the more profit Ford generates, the more dividends the stockholders will likely receive while Ford reinvests some of the remaining profit—called **retained earnings**—into the company to generate additional profit in the future. In essence, what Ford tries to do is to **maximize shareholder wealth** (dividends plus the increase in the stock prices over time). By purchasing Ford Motor Company's stocks, the Ford stockholder puts her or his money and faith in Ford's management. Ford's management believes that its obligation is to maximize shareholder wealth. The greater the dividends that Ford shareholders receive and the higher that Ford stock prices rise, the happier the investors are and the more willing they will be to buy and hold Ford stocks.

dividends The portion of profits distributed to stockholders.

retained earnings The portion of profits not distributed as dividends but reinvested back into the company to generate additional profits in the future.

maximize shareholder wealth Corporate policies that lead to high dividend payments and rising stock prices over a period of time.

Maximizing Stakeholder Wealth

In the United States, employees (labor) at firms and corporations are generally looked on as a factor of production just like land and capital. When the U.S. economy slows or a company is not doing well for various reasons, the U.S. norm is to lay off workers (shed excess labor) to reduce cost until profits improve. Despite unemployment compensation benefits paid by the government, laid-off workers and their families go through tremendous economic and psychological stress and hardship. The Europeans and Japanese do not like the U.S. approach. They believe that the U.S. system of laying off workers is too ruthless (which it is!) since from their point of view, employees are more than mere factors of production—they are humans—and therefore need to be treated better. Many European managers believe in a broader corporate objective than maximizing shareholder wealth. Supported by European public opinion, these business leaders would like to maximize stakeholder wealth and move toward a stakeholder society rather than a purely shareholder society. There is tremendous debate in Europe and Asia, and to a lesser extent in the United States (except during national elections), on the merits of a **stakeholder company**—one that does not focus exclusively on shareholder wealth maximization and its short-term interests but that takes into consideration the welfare of all its constituents: customers, management, employees, suppliers, and society. While measuring shareholder wealth is relatively straightforward, measuring stakeholder wealth and maximizing it can get a bit difficult. For example, in the latter case, companies are obliged to keep redun-

stakeholder company A business that takes into consideration the interests of all its partners, including its customers, management, employees, suppliers, and society.

ETHICS IN BUSINESS

Corporate Profits Versus Corporate Ethics

The U.S. business system focuses on maximizing short-term profits; stock analysts as well as investors continually focus on the quarterly profit performance of companies. Corporate managers (whose salaries and bonuses are often tied to corporate performance) in turn try their best to meet short-term expectations—maximizing corporate profits and boosting stock prices! Recent events, especially in corporate America, have brought the issue of **business ethics** to the forefront. Business ethics deals with questions about whether certain business practices (some of which may be legal) are morally acceptable, especially when they have a detrimental impact on consumers, investors, or employees—compromising long-term corporate viability for short-term gain by encouraging various forms of corporate (especially accounting and financial) scandals. For example, the American Credit Crisis of 2008 revealed a wide array of scandalous corporate behavior that tarnished the reputations of some of the United States' largest financial institutions. While the facts in each case have varied somewhat, the downfall of several major financial institutions (e.g., Bear Stearns, Lehman Brothers, Countrywide Financial, Washington Mutual, Citigroup, Bank of America, Goldman Sachs, AIG) can be attributed to a common thread: unethical behavior of key corporate executives that had been tolerated for years, often with regulators and industry insiders looking the other way. These corporate scandals were generally the result of executives boosting short-term revenues/earnings and artificially inflating their corporation's stock prices.

These developments, which had the worst effect on the U.S. economy since the Great Depression of 1929–1933, also had significant detrimental effects on investors (especially retirees and those with retirement plans) as well as employees of those companies. This led to a public outcry and investigations by the U.S. Congress that showed how corporate executives misled investors by touting financial derivatives publicly that they denigrated privately in order to win lucrative investment banking business. These events have raised serious discussions in Congress and in academia about the need to tighten financial regulations through the "Frank–Dodd Bill" to improve corporate ethics and curtail white-collar crime.

QUESTIONS

1. Should financial institutions be regulated more tightly? Or can market forces rectify the situation? Or is better government regulation and supervision needed? Is this a case of a few rotten apples, or is the problem systemic?
2. Why do you think so many well-known U.S. firms have been involved in unethical behavior, especially when compared with the relatively few cases in Europe and Japan?

dant employees and share some of society's cost. Europeans believe strongly that in the long term, such a socially responsible company will be better off than businesses that are exclusively based on shareholder wealth creation. In stakeholder-oriented companies, employees are considered more than a factor of production, and they cannot be hired or fired easily. As a comparison of equity, the ratio of salary paid to the chief executive of a company to that of an average factory worker is close to 50:1 in Europe and Japan, while it is close to 400:1 in the United States. As Warren Buffet, the Sage of Omaha, indicated in Berkshire Hathaway's 2003 annual letter (March 7, 2004) to shareholders, "In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging."

business ethics The principles governing whether certain business practices are morally acceptable, especially when they have a detrimental impact on consumers, investors, or employees.

Minimizing Unemployment and Income Inequalities

In several developing countries of Africa, Asia, the former Soviet bloc, and Latin America, the primary objective of many large companies is to keep people employed. Invariably, these companies are government-owned state enterprises. While many of these state enterprises, especially in China and India, are currently being sold to private entrepreneurs in the process called privatization, a significant number of state enterprises still exist in the Middle East, Central Asia, and Latin America. Most governments consider state enterprises a source of employment generation. As a result, state enterprises tend to be overstaffed, and the employees are invariably underpaid. Also, the productivity of state enterprise employees is generally very low. This creates a vicious cycle. Because

productivity The dollar output of goods and services per dollar input of labor.

the employees are poorly paid, they do not work hard. Since they do not work hard (they hardly work in many cases!), **productivity** (dollar output of goods and services per dollar input of labor) is low and they are entitled only to low wages. There is generally a total lack of motivation on the part of these employees and managers to work hard and perform well, since employees and management are not rewarded on the basis of profits. The tendency of workers and managers alike is to do the minimum needed to get by.

A related objective of state enterprises is to minimize income inequalities. In the free enterprise system, anyone with a good business idea can start a firm and operate it within the rule of law. Those with ideas, initiative, and resources can become rich, while those with no ideas, initiative, or resources are likely to be left behind. Thus, in the free market system, we can see that those who work hard are likely to succeed and earn a decent living, while those who do not work hard may not be well off. Politicians in some countries do not consider this to be appropriate (since the rich seem to get richer and the poor, poorer) and have favored state enterprises, where wage differences between management and factory workers are not large, thereby minimizing income inequalities among workers. The drawback of this system is that it focuses too much effort on income redistribution and not much emphasis on increasing efficiency and generating profits and economic growth.

Not-for-Profit Organizations

The primary objective of these organizations is to serve society. Since these organizations are not-for-profit, they are exempt from paying corporate taxes. Not-for-profit organizations have an extremely important role to play in an economy. They provide goods and services that would otherwise not be made available and without which society as a whole would be worse off. There are hundreds of local (Boy Scouts and Girl Scouts), state (Adapt of Texas), national (Salvation Army), and international (Catholic Relief Services) not-for-profit organizations that are vital for the well-being of society.

Take educational institutions, for example. Although one may think or feel that these schools or universities are out to make a profit, that is not true. Public schools are funded by taxpayer dollars, and there is a constant challenge for governments to manage within state-allocated budgets. State universities receive some government funding, which is generally not adequate, and universities charge students tuition and fees to cover the cost of instruction, lab equipment, and campus facilities. Universities also use income from endowments (donations from alumni or corporations) to defray some costs. Private universities operate in a similar fashion to public universities. All these institutions try to manage within their budgets, and when there is a surplus (not a profit), those monies are saved for emergencies or for future capital (campus) improvements. There are numerous other national and international not-for-profit charitable organizations. These include the international not-for-profit agencies like UNICEF, Doctors Without Borders, and World Vision. These charities reach out to people who need help and improve their quality of life.

✔ Reality Check

Do you feel that the rich are getting richer and the poor are getting poorer in your country? Why?

Demand for Goods and Services

LEARNING OBJECTIVE 8

Explain the important role consumers play in determining corporate performance and show how businesses try to identify consumer needs.

inventory Unsold goods in stock.

Firms are in the business of producing goods or providing services for customers. Without customers, businesses will cease to exist and unemployment will increase. Consumers, therefore, are extremely important for business success as well as for the well-being of the country as a whole. Approximately 70 percent of the U.S. economic output is based on private consumption. So when the U.S. consumer curtails her or his spending habits, the demand for goods and services is at once negatively affected and private consumption shrinks; this leads to **inventory**—unsold goods—buildup. When inventory buildup reaches a certain level, businesses cut down production and lay off workers, and the economy contracts. The role of the consumer, regardless of the country under consideration, is paramount for business growth and profitability. Businesses constantly try to identify consumer needs in order to develop products and services that can be sold profitably.

Measuring Consumer Confidence

Given the crucial role consumers play in an economy, businesses are eager to know how positive consumers feel about themselves and their environment. If consumers feel great about their jobs, their job security, their salaries, and their general home environment, they are likely to spend freely on all types of items, thereby boosting business revenue and economic growth. Government policymakers are always happy to see their economy grow for several simple reasons. Steady economic growth implies that businesses are doing well and are generating profits. When businesses do well, they employ more people and also pay more corporate taxes. The resulting high rate of employment in turn generates more income taxes for the government and also reduces unemployment benefits and social problems like crime. For these reasons, businesses as well as economists are interested in knowing the level of consumer confidence, that is, how satisfied consumers feel about themselves, the economy, and their spending habits.

A closely watched measure of consumer confidence is the **Consumer Confidence Index**, which is put out monthly by the Conference Board, **www.conferenceboard.org**, in New York. The Conference Board is a not-for-profit organization that works as a global, independent membership organization serving the public interest. The Consumer Confidence Index is based on the Consumer Confidence Survey, **www.conference-board.org/data/consumerconfidence.cfm**, which samples 5000 U.S. households monthly. For example, that index, increased marginally in July 2018 to 127.4 up from 127.1 in June 2018 (1985 = 100). When the index rises, it indicates that consumers are more confident about *current* business conditions. This implies that consumers may continue spending, and this in turn could affect business revenues and earnings. A drop in the Consumer Confidence Index sends a message to firms that they should not be optimistic about the immediate business environment and may want to curb investment or expansion plans. Economists get very concerned, since these actions may raise unemployment and reduce corporate profits and income tax revenues. A related index put out by the Conference Board is the Expectations Index, which measures the consumer outlook for the short term. When this index rises, it indicates that, overall, consumers are optimistic about the short-term outlook for the U.S. economy.

Consumer Confidence Index An indicator that measures the self-assurance of consumers and is crucial in determining consumer spending habits that have a direct impact on business prospects and the economy.

The Consumer Knows Best

Given the fact that businesses depend heavily on consumers for their survival, the questions in every businessperson's mind are, Who is the consumer? Are all consumers alike? Do culture, income, demographics, national boundaries, and so on impact a consumer's purchasing habits and purchasing power? If so, how and why? Properly identifying, understanding, and serving customer needs is key to business success. Regardless of what businesspeople think, it is ultimately the consumer who calls the shots. Quite often businesses come up with a relatively novel product or service, but the consumer may not be ready for it. The consumer may find the particular product or service to be of little value to him or her, and this may result in that business's failure. The test of business success is in the market, and in the market the consumer rules!

Source: Nejron Photo/Shutterstock.com.

Group of millennials with different studying habits preparing for exams.

Consumer Demographics and Psychographics

The United States is currently the world's largest consumer market. It is also the world's largest economy with one of the lowest unemployment rates. In addition, the United States is the world's largest importer and exporter of goods and services. According to the U.S. Census Bureau, for example, 50.5 percent of the U.S. population of some 326 million in 2017 is female; 13 percent is African American and 16 percent is Hispanic; approximately 7 percent of the population is in the 15-to-19-year age group, 13.4 percent is in the 25-to-34-year age group, 13 percent is in the 35-to-44-year age group, and 14.2 percent is in the 45-to-54-year age group (highest concentration). Furthermore, currently 26 percent of the U.S. population is over 55 years old, and this population group is expected to increase to 31 percent by 2050.[9] And the Hispanic population is projected to rise to 24 percent by 2050. What do all these statistics mean to business? Does anyone care? Yes, these statistics reflect the diversity of U.S. consumers and are of great interest to businesses as they try to determine what to produce and for whom. For example, magazine publishers in the United States have analyzed this information to come up with such magazines as *Black Enterprise*, *Golf for Women*, *Latina Magazine*, *Seventeen*, and *Sports Illustrated for Kids* to cater precisely to the needs of specific audiences. Among the wealth of statistics available from the Census Bureau is information on where and how the U.S. population is distributed. That information enables businesses to identify the right location for manufacturing and marketing different products and services.

We all know that not all consumers are alike. People have different tastes (and therefore different needs for goods and services), which might depend on various demographic and social characteristics like *gender*, *age*, *race*, *national origin*, *income*, *education*, *employment*, *physical location or residence*, *sexual orientation*, and *marital status*. However, a group of people can be identified who have similar tastes and who for all practical purposes can be lumped together as one of several target groups that businesses may want to cater to. Depending on the type and number of consumers in it, the target group may have a critical mass, a size that makes business viable. A **target group** could be U.S. millennials who, as defined by the Pew Research Center, are those who currently (2018) are in the 22-to-37-year age group and constitute 73 million of the U.S. population. They are no longer teenagers or students and have reached the most important age range for economic activity and will also overtake the baby boomers in number by 2020. Since some 43 percent of U.S. millennials are nonwhites and all millennials have integrated technology into their lives and habits, businesses are scrambling to identify and adjust to millennial tastes and spending habits.

target group A population segment whose members have more or less similar consumption habits.

Mercedes Benz cars, for example, have traditionally been purchased by a specific segment of the U.S. population, that is, those with relatively *high income* and around *middle age*. Income and age are some of the demographic characteristics that DaimlerBenz uses for **market segmentation**. Mercedes Benz's new cars come loaded with high-tech devises to meet the perceived needs of millennials. Depending on the product or service that is being considered, businesses may include product-specific demographics. **Psychographics**, on the other hand, deals with an analysis and understanding of the consumer's mind to identify likes, dislikes, or preferences and to develop commercials that try to manipulate the recipient's mind to create a desire for certain goods or services. Here businesses try to go across demographics to identify and arouse certain consumer tastes to sell their products, for example, Samsung or Apple smart phones.

market segmentation The breakdown of target consumers into categories on the basis of age, gender, education, ethnic background, or other criteria to determine the products or services that could be made to suit the segments' specific needs.

psychographics The analysis and understanding of the consumer's mind to identify consumer likes, dislikes, or preferences and develop commercials that manipulate the recipient's mind to create a need for certain new goods or services.

Cultural Diversity

Culture plays an extremely important role in business, especially in such functional areas as human resource management and marketing. Domestic and international companies that have been successful in identifying, designing, and implementing strategies that take into consideration cultural differences in their business environments are the ones that are most likely to succeed. Businesses, big and small, are slowly recognizing that to succeed, they must please individual customers of many national origins with many different national cultures.

The challenge with culture is that it is as easy to grasp as a wet frog. Yet, cultural awareness is paramount to business success. Culture underpins all human activities, explains much of our behavior, and creates awareness for learning. Cultural differences

culture The behavior patterns, beliefs, and institutions that underpin all human activities, explain much of our behavior, create an awareness for learning, and vary by social grouping.