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Preface

Welcome to *Introduction to Business*, an OpenStax resource. This textbook was written to increase student access to high-quality learning materials, maintaining highest standards of academic rigor at little to no cost.

About OpenStax

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About OpenStax resources

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Format

You can access this textbook for free in web view or PDF through OpenStax.org, and for a low cost in print.

About *Introduction to Business*

Introduction to Business is designed to meet the scope and sequence requirements of foundational business courses. The textbook presents business principles and emerging trends in fields including management, leadership, production, marketing, and finance. Through this content, students will acquire the knowledge, skills, and competencies to prepare for the competitive workplace.

Coverage and scope

Introduction to Business covers the scope and sequence of most introductory business courses. The book provides detailed explanations in the context of core themes such as ethics, entrepreneurship, customer satisfaction, global business, and managing change. *Introduction to Business* includes hundreds of current business examples from a range of industries, geographic locations, and featuring a variety of individuals. The outcome is a balanced approach to the theory and application of business concepts, with attention to the knowledge and skills necessary for student success in this course and beyond.

Pedagogical foundation

Consistent, integrated learning. Targeted learning outcomes are listed at the beginning of each chapter and then repeated throughout the chapter. The learning outcomes connect to the text and the additional resources that accompany *Introduction to Business*. After reading each section, students can test their retention by answering the questions in the Concept Checks. Every learning goal is further reinforced by a summary.

Hundreds of business examples to bring concepts to life. This book is designed to speak to the typical student. We have done a lot of research about student needs, abilities, experiences, and interests, and then we have shaped the text around them. We have used experiences both inside and outside the classroom to enrich a book that is both readable and enjoyable. We believe that the real business applications found throughout every chapter set the standard for readability and understanding of key concepts.

Learning business terminology, made easy. As students begin to study business, they will explore new words and concepts. To help them learn this language of business, we define each new term in the chapter, display the terms in bold, and offer a complete glossary at the end of the book.

Engaging business themes

Ethics. Business presents outstanding opportunities to do good. Through responsible business practices and the development and distribution of helpful products and services, businesspeople can positively affect their community. A paramount theme of this text is that business must be conducted in an ethical and socially responsible manner. **Chapter 2**, Making Ethical Decisions and Managing a Socially Responsible Business, is completely devoted to business ethics and social responsibility. We discuss techniques for setting personal ethical standards, how managers influence organizational ethics, tools for creating employee ethical awareness, and the concept of individual and corporate responsibility. *Introduction to Business* also features ethics activities at the end of each chapter. All ethical dilemmas are taken right out of today's business world.

Customer satisfaction and quality. Because customer satisfaction and quality are the foundation of all business principles, these important topics are addressed in most chapters within *Introduction to Business*. Each chapter stresses that satisfied customers who experience high-quality products and services become loyal customers. A box in every chapter called "Customer Satisfaction and Quality" demonstrates how these concepts are applied in actual companies.

Managing change. Change in the business or consumer environment can lead to failures like Kodak's and

successes like Apple's. The Managing Change boxed feature describes how companies have recognized and responded to changes in technology, competition, economic forces, demographics, and culture.

Entrepreneurship and small business management. Because many students will either open their own businesses or go to work for small organizations, entrepreneurship and small business principles are covered throughout the text. [**Chapter 5**](#), Entrepreneurship: Starting and Managing Your Own Business, delivers interesting discussions on starting and managing a small business and the associated advantages and disadvantages. In addition, a feature called "Catching the Entrepreneurial Spirit" offers practical insights into the challenges and rewards of actually owning and managing a small business.

Global business economy. In [**Chapter 3**](#), Competing in the Global Marketplace, we discuss why global trade is important to the United States, why nations trade, barriers to international trade, how companies enter the global marketplace, and a host of other international concepts and topics. The Trends section of each chapter frequently includes a discussion of how globalization will affect specific business activities. In addition, our Global Business box demonstrates how businesses are expanding their workforce, products, and customer base throughout the world in order to grow.

Features

Rather than provide a dry recitation of facts, we illustrate concepts with contemporary examples. In addition to the in-text examples, we have several boxed features that provide more extensive examples in areas of importance in today's business environment. Each of the boxed features described below includes a series of critical thinking questions to prompt the student to consider the implications of each business strategy.

Ethics in Practice. Ethics in Practice features demonstrate how businesses are responsible not only to the bottom line, but to providing goods and services in a responsible manner.

Customer Satisfaction and Quality. Because customer satisfaction and quality are essential to attracting and keeping customers, the Customer Satisfaction and Quality box addresses how these concepts are illustrated and applied in actual companies.

Expanding Around the Globe. Upon entering today's workplace, you are very likely to conduct business with colleagues, clients, and vendors from around the world. The Expanding Around the Globe feature offers insights into the global economy and highlights the strategies firms take to expand their business and improve their productivity by utilizing global resources.

Managing Change. The turbulent business climate requires companies to adapt their business strategies in response to a variety of economic, social, competitive, and technological forces. The Managing Change feature highlights how businesses have altered their business strategies in response to these forces.

Catching the Entrepreneurial Spirit. This feature highlights the challenges and opportunities available in small businesses and other entrepreneurial ventures.

Activities and cases that put knowledge to work

Introduction to Business helps students develop a solid grounding in the skills that they can apply in the workplace. These skill-building activities and resources help build and polish competencies that future employers will value.

Preparing for tomorrow's workplace skills and team activities. These activities are designed to help build students' business skills and to help them practice teamwork. We have developed assignments focused on five important workplace competencies: using and allocating resources, working with others, acquiring and using information, understanding systems, and working with technology. Team activities in every chapter give

students an opportunity to work together, building communication skills and interpersonal skills.

Ethics activities. Ethics activities at the end of each chapter present real-world ethical challenges and prompt students to choose the most ethical course of action.

Working the net activities. These activities guide students through a step-by-step analysis of actual e-business practices and give them opportunities to build online research skills.

Creative thinking cases. The Creative Thinking case in each chapter invites students to explore business strategies of various companies, analyze business decisions, and prepare comments.

Additional resources

Community Hubs

OpenStax partners with the Institute for the Study of Knowledge Management in Education (ISKME) to offer Community Hubs on OER Commons – a platform for instructors to share community-created resources that support OpenStax books, free of charge. Through our Community Hubs, instructors can upload their own materials or download resources to use in their own courses, including additional ancillaries, teaching material, multimedia, and relevant course content. We encourage instructors to join the hubs for the subjects most relevant to your teaching and research as an opportunity both to enrich your courses and to engage with other faculty.

To reach the Community Hubs, visit www.oercommons.org/hubs/OpenStax.

Student and instructor resources

We've compiled additional resources for both students and instructors, including Getting Started Guides, an instructor's manual, test bank, and image slides. Instructor resources require a verified instructor account, which you can apply for when you log in or create your account on OpenStax.org. Take advantage of these resources to supplement your OpenStax book.

Comprehensive instructor's manual. Each component of the instructor's manual is designed to provide maximum guidance for delivering the content in an interesting and dynamic manner. The instructor's manual includes an in-depth lecture outline, which is interspersed with lecture "tidbits" that allow instructors to add timely and interesting enhancements to their lectures. Authored by Linda Hefferin, Elgin Community College.

Test bank. With nearly 2,000 true/false, multiple-choice, fill-in-the-blank, and short answer questions in our test bank, instructors can customize tests to support a variety of course objectives. The test bank is available in Word format. Authored by Amit Shah, Frostburg State University.

PowerPoint lecture slides. The PowerPoint slides provide images and descriptions as a starting place for instructors to build their lectures.

Technology partners

As allies in making high-quality learning materials accessible, our technology partners offer optional low-cost tools that are integrated with OpenStax books. To access the technology options for your text, visit your book page on OpenStax.org.

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1

Understanding Economic Systems and Business

Exhibit 1.1 (Credit: Marco Verch /flickr / Attribution 2.0 Generic (CC BY 2.0))



Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. How do businesses and not-for-profit organizations help create our standard of living?
2. What are the sectors of the business environment, and how do changes in them influence business decisions?
3. What are the primary features of the world's economic systems, and how are the three sectors of the U.S. economy linked?
4. How do economic growth, full employment, price stability, and inflation indicate a nation's economic health?
5. How does the government use monetary policy and fiscal policy to achieve its macroeconomic goals?
6. What are the basic microeconomic concepts of demand and supply, and how do they establish prices?
7. What are the four types of market structure?
8. Which trends are reshaping the business, microeconomic, and macroeconomic environments and competitive arena?

EXPLORING BUSINESS CAREERS

Team Rubicon: Disaster Relief and a Sense of Purpose

Accounting for a substantial amount of economic activity in the United States, not-for-profits are an undeniable force in the business world, even though their focus on goals other than profit falls outside

the traditional model of a for-profit business. But it is this shift away from a focus on profit that allows them to pursue missions of social improvement and contributions to society as a whole. To be truly effective in a not-for-profit organization, a person must share the organization's vision.

The vision for Team Rubicon was shaped by its cofounders, Jake Wood and William McNulty, who saw the devastation caused by the Haiti earthquake in 2010 and sprang into action. Both marines, Wood and McNulty knew they could do something to help in this devastating and chaotic situation. Within 24 hours, they enlisted the help of six other military veterans and first responders, gathered donations and supplies from friends and family, and made their way to Haiti to help with disaster relief, and Team Rubicon was born.



Exhibit 1.2 Team Rubicon (Credit: Bureau of Land Management Oregon and Washington/flickr/ Attribution 2.0 Generic (CC BY 2.0))

The organization gets its name from the Rubicon, a river in northern Italy that Julius Caesar and his troops crossed on their epic march to Rome, with the river marking the point of no return. The name underscores the cofounders' experiences during the Haitian disaster, where despite advice from government officials and other aid organizations not to proceed, their small team crossed into Haiti from the Dominican Republic carrying crucial gear and medical supplies to thousands of earthquake victims.

Seven years later, Team Rubicon's mission is twofold: to pair the skills and experiences of military veterans with first responders to hit the ground running in any type of disaster and to provide a sense of community and accomplishment to veterans who have served their country proudly but may be struggling as a result of their war experiences.

According to the organization's mission statement, Team Rubicon seeks to provide veterans three things

they sometimes lose after leaving the military: a purpose, gained through disaster relief; a sense of community, built by serving with others; and a feeling of self-worth from recognizing the impact one individual can make when dealing with natural disasters.

Headquartered in the Los Angeles area, Team Rubicon is staffed by more than 60 employees who work in 10 regions around the country, along with more than 40,000 volunteers ready to deploy within 24 hours. Similar to company operations in for-profit organizations, staff positions at Team Rubicon include regional administrators; field operations (including membership and training); marketing, communications, and social media; fundraising and partnership development; finance and accounting; and people operations.

Team Rubicon's staff members bring professional and/or military experience to their daily jobs, but they all share the organization's vision. Many staff members started as volunteers for Team Rubicon while working in for-profit careers, while others took advantage of the organization's strong internship program to become familiar with its mission and focus on disaster relief.

In 2016, Team Rubicon trained 8,000 military veterans and first responders in disaster relief and responded to 46 disasters, which required more than 85,000 volunteer hours. In addition to donations from individuals and corporations, Team Rubicon relies on its partnerships with other organizations, such as Southwest Airlines, which supplies hundreds of free plane tickets each year to fly volunteers to disaster sites.

Team Rubicon actively engages its nationwide community at every level of the organization, from volunteer to board member, and every step of its operation: from training to planning to implementation to seeking donations and volunteers to help with any type of disaster relief. Over the past several years, Team Rubicon has been recognized as one of the top nonprofits to work for by *The NonProfit Times*, based on employee surveys and business partners' input about the organization's work environment.

The not-for-profit world may not be for everyone, but if its growth is any indication within the overall economy, it does appeal to many. With a resolve to assist those in need, including both disaster victims and returning military personnel, Team Rubicon offers opportunities for those interested in nonprofit careers as well as those passionate about helping others.

Sources: Company website, "Our Mission" and "Staff & Board," <https://teamrubiconusa.org>, accessed May 29, 2017; Mark Hrywna, "2017 NPT Best Nonprofits to Work," *The NonProfit Times*, <http://thenonprofittimes.com>, accessed May 27, 2017; Mark Hrywna, "2016 NPT Best Nonprofits to Work," *The NonProfit Times*, <http://thenonprofittimes.com>, accessed May 27, 2017; Kyle Dickman, "The Future of Disaster Relief Isn't the Red Cross," *Outside*, <https://www.outsideonline.com>, August 25, 2016.

This module provides the basic structures upon which the business world is built: how it is organized, what outside forces influence it, and where it is heading. It also explores how the world's economies and governments shape economic activity. Each day in the United States, thousands of new businesses are born. Only a rare few will become the next Apple, Google, or Amazon. Unfortunately, many others will never see their first anniversary. The survivors are those that understand that change is the one constant in the business environment. Those organizations pay attention to the business environment in which they operate and the trends that affect all businesses and then successfully adapt to those trends. In this module, we will meet many businesses, both large and small, profit and not-for-profit, that prosper because they track trends and use them to identify potential opportunities. This ability to manage change is a critical factor in separating the

success stories from the tales of business failure.

We begin our study of business by introducing you to the primary functions of a business, the relationship between risk and profits, and the importance of not-for-profit organizations. We'll also examine the major components of the business environment and how changing demographic, social, political and legal, and competitive factors affect all business organizations. Next, we'll explore how economies provide jobs for workers and also compete with other businesses to create and deliver products to consumers. You will also learn how governments attempt to influence economic activity through policies such as lowering or raising taxes. Next, we discuss how supply and demand determine prices for goods and services. Finally, we conclude by examining key trends in the business environment, economic systems, and the competitive environment.

1.1 The Nature of Business

1. How do businesses and not-for-profit organizations help create our standard of living?

Take a moment to think about the many different types of businesses you come into contact with on a typical day. As you drive to class, you may stop at a gas station that is part of a major national oil company and grab lunch from a fast food chain such as Taco Bell or McDonald's or the neighborhood pizza place. Need more cash? You can do your banking on a smartphone or other device via mobile apps. You don't even have to visit the store anymore: online shopping brings the stores to you, offering everything from clothes to food, furniture, and concert tickets.

A **business** is an organization that strives for a profit by providing goods and services desired by its customers. Businesses meet the needs of consumers by providing medical care, autos, and countless other goods and services. **Goods** are tangible items manufactured by businesses, such as laptops. **Services** are intangible offerings of businesses that can't be held, touched, or stored. Physicians, lawyers, hairstylists, car washes, and airlines all provide services. Businesses also serve other organizations, such as hospitals, retailers, and governments, by providing machinery, goods for resale, computers, and thousands of other items.

Thus, businesses create the goods and services that are the basis of our standard of living. The **standard of living** of any country is measured by the output of goods and services people can buy with the money they have. The United States has one of the highest standards of living in the world. Although several countries, such as Switzerland and Germany, have higher average wages than the United States, their standards of living aren't higher, because prices are so much higher. As a result, the same amount of money buys less in those countries. For example, in the United States, we can buy an Extra Value Meal at McDonald's for less than \$5, while in another country, a similar meal might cost as much as \$10.

Businesses play a key role in determining our quality of life by providing jobs and goods and services to society. **Quality of life** refers to the general level of human happiness based on such things as life expectancy, educational standards, health, sanitation, and leisure time. Building a high quality of life is a combined effort of businesses, government, and not-for-profit organizations. In 2017, Vienna, Austria, ranked highest in quality of life, followed by Zurich, Switzerland; Auckland, New Zealand; and Munich, Germany. It may come as a surprise that not one of the world's top cities is in the United States: seven of the top 10 locations are in western Europe, two are in Australia/New Zealand, and one is in Canada. At the other end of the scale, Baghdad, Iraq, is the city scoring the lowest on the annual survey.¹ Creating a quality of life is not without risks, however. **Risk** is the potential to lose time and money or otherwise not be able to accomplish an organization's goals. Without enough blood donors, for example, the American Red Cross faces the risk of not meeting the demand for blood by victims of disaster. Businesses such as Microsoft face the risk of falling short of their revenue and profit goals. **Revenue** is the money a company receives by providing services or selling goods to customers. **Costs** are expenses for rent, salaries, supplies, transportation, and many other items that

a company incurs from creating and selling goods and services. For example, some of the costs incurred by Microsoft in developing its software include expenses for salaries, facilities, and advertising. If Microsoft has money left over after it pays all costs, it has a **profit**. A company whose costs are greater than revenues shows a loss.

When a company such as Microsoft uses its resources intelligently, it can often increase sales, hold costs down, and earn a profit. Not all companies earn profits, but that is the risk of being in business. In U.S. business today, there is generally a direct relationship between risks and profit: the greater the risks, the greater the potential for profit (or loss). Companies that take too conservative a stance may lose out to more nimble competitors who react quickly to the changing business environment.

Take Sony, for example. The Japanese electronics giant, once a leader with its Walkman music player and Trinitron televisions, steadily lost ground—and profits—over the past two decades to other companies by not embracing new technologies such as the digital music format and flat-panel TV screens. Sony misjudged what the market wanted and stayed with proprietary technologies rather than create cross-platform options for consumers. Apple, at the time an upstart in personal music devices, quickly grabbed the lion's share of the digital music market with its iPods and iTunes music streaming service. By 2016, Sony restructured its business portfolio and has experienced substantial success with its PlayStation 4 gaming console and original gaming content.²

Not-for-Profit Organizations

Not all organizations strive to make a profit. A **not-for-profit organization** is an organization that exists to achieve some goal other than the usual business goal of profit. Charities such as Habitat for Humanity, the United Way, the American Cancer Society, and the World Wildlife Fund are not-for-profit organizations, as are most hospitals, zoos, arts organizations, civic groups, and religious organizations. Over the last 20 years, the number of nonprofit organizations—and the employees and volunteers who work for them—has increased considerably. Government is our largest and most pervasive not-for-profit group. In addition, more than 1.5 million nongovernmental not-for-profit entities operate in the United States today and contribute more than \$900 billion annually to the U.S. economy.³

Like their for-profit counterparts, these groups set goals and require resources to meet those goals. However, their goals are not focused on profits. For example, a not-for-profit organization's goal might be feeding the poor, preserving the environment, increasing attendance at the ballet, or preventing drunk driving. Not-for-profit organizations do not compete directly with one another in the same manner as, for example, Ford and Honda, but they do compete for talented employees, people's limited volunteer time, and donations.



Exhibit 1.3 Rescue boat Following Hurricane Irma affected The island of Puerto Rico, the Kentucky and Haraii National Guard assisted storm victims by donating to disaster relief efforts. Some not-for-profit charities focused aid toward the people of the region, but others delivered care to a different group of sufferers: animals and pets. Although most animal hospitals are not normally a refuge for displaced animals, many facilities opened their doors to pet owners affected by the torrential rains. *Why are tasks such as animal rescue managed primarily through not-for-profit organizations?* (Credit: Hawaii and Kentucky National Guard /flickr /Attribution 2.0 Generic (CC BY))

The boundaries that formerly separated not-for-profit and for-profit organizations have blurred, leading to a greater exchange of ideas between the sectors. As discussed in detail in the ethics chapter, for-profit businesses are now addressing social issues. Successful not-for-profits apply business principles to operate more effectively. Not-for-profit managers are concerned with the same concepts as their colleagues in for-profit companies: developing strategy, budgeting carefully, measuring performance, encouraging innovation, improving productivity, demonstrating accountability, and fostering an ethical workplace environment.

In addition to pursuing a museum's artistic goals, for example, top executives manage the administrative and business side of the organization: human resources, finance, and legal concerns. Ticket revenues cover a fraction of the museum's operating costs, so the director spends a great deal of time seeking major donations and memberships. Today's museum boards of directors include both art patrons and business executives who want to see sound fiscal decision-making in a not-for-profit setting. Therefore, a museum director must walk a fine line between the institution's artistic mission and financial policies. According to a survey by *The Economist*, over the next several years, major art museums will be looking for new directors, as more than a third of the current ones are approaching retirement.⁴

Factors of Production: The Building Blocks of Business

To provide goods and services, regardless of whether they operate in the for-profit or not-for-profit sector, organizations require inputs in the form of resources called **factors of production**. Four traditional factors of

production are common to all productive activity: *natural resources, labor (human resources), capital, and entrepreneurship*. Many experts now include *knowledge* as a fifth factor, acknowledging its key role in business success. By using the factors of production efficiently, a company can produce more goods and services with the same resources.

Commodities that are useful inputs in their natural state are known as natural resources. They include farmland, forests, mineral and oil deposits, and water. Sometimes natural resources are simply called land, although, as you can see, the term means more than just land. Companies use natural resources in different ways. International Paper Company uses wood pulp to make paper, and Pacific Gas & Electric Company may use water, oil, or coal to produce electricity. Today urban sprawl, pollution, and limited resources have raised questions about resource use. Conservationists, environmentalists, and government bodies are proposing laws to require land-use planning and resource conservation.

Labor, or human resources, refers to the economic contributions of people working with their minds and muscles. This input includes the talents of everyone—from a restaurant cook to a nuclear physicist—who performs the many tasks of manufacturing and selling goods and services.

The tools, machinery, equipment, and buildings used to produce goods and services and get them to the consumer are known as **capital**. Sometimes the term *capital* is also used to mean the money that buys machinery, factories, and other production and distribution facilities. However, because money itself produces nothing, it is not one of the basic inputs. Instead, it is a means of acquiring the inputs. Therefore, in this context, capital does not include money.

Entrepreneurs are the people who combine the inputs of natural resources, labor, and capital to produce goods or services with the intention of making a profit or accomplishing a not-for-profit goal. These people make the decisions that set the course for their businesses; they create products and production processes or develop services. Because they are not guaranteed a profit in return for their time and effort, they must be risk-takers. Of course, if their companies succeed, the rewards may be great.

Today, many individuals want to start their own businesses. They are attracted by the opportunity to be their own boss and reap the financial rewards of a successful firm. Many start their first business from their dorm rooms, such as Mark Zuckerberg of Facebook, or while living at home, so their cost is almost zero.

Entrepreneurs include people such as Microsoft cofounder Bill Gates, who was named the richest person in the world in 2017, as well as Google founders Sergey Brin and Larry Page.⁵ Many thousands of individuals have started companies that, while remaining small, make a major contribution to the U.S. economy.

CATCHING THE ENTREPRENEURIAL SPIRIT



StickerGiant Embraces Change

Entrepreneurs typically are not afraid to take risks or change the way they do business if it means there is a better path to success. John Fischer of Longmont, Colorado, fits the profile.

The drawn-out U.S. presidential election in 2000 between Bush and Gore inspired Fischer to create a bumper sticker that claimed, “He’s Not My President,” which became a top seller. As a result of this venture, Fischer started an online retail sticker store, which he viewed as possibly the “Amazon of Stickers.” Designing and making stickers in his basement, Fischer’s start-up would eventually become a

multimillion-dollar company, recognized in 2017 by *Forbes* as one of its top 25 small businesses.

The StickerGiant online store was successful, supplying everything from sports stickers to ones commemorating rock and roll bands and breweries. By 2011, the business was going strong; however, the entrepreneur decided to do away with the retail store, instead focusing the business on custom orders, which became StickerGiant's main product.

As the company became more successful and added more employees, Fischer once again looked to make some changes. In 2012 he decided to introduce a concept called open-book management, in which he shares the company's financials with employees at a weekly meeting. Other topics discussed at the meeting include customer comments and feedback, employee concerns, and colleague appreciation for one another. Fischer believes sharing information about the company's performance (good or bad) not only allows employees to feel part of the operation, but also empowers them to embrace change or suggest ideas that could help the business expand and flourish.

Innovation is also visible in the technology StickerGiant uses to create miles and miles of custom stickers (nearly 800 miles of stickers in 2016). The manufacturing process involves digital printing and laser-finishing equipment. Fischer says only five other companies worldwide have the laser-finishing equipment StickerGiant uses as part of its operations. Because of the investment in this high-tech equipment, the company can make custom stickers in large quantities overnight and ship them to customers the next day.

This small business continues to evolve with an entrepreneur at the helm who is not afraid of making changes or having fun. In 2016, StickerGiant put together Saul the Sticker Ball, a *Guinness World Records* winner that weighed in at a whopping 232 pounds. Fischer and his employees created Saul when they collected more than 170,000 stickers that had been lying around the office and decided to put them to good use. With \$10 million in annual sales and nearly 40 employees, StickerGiant continues to be a successful endeavor for John Fischer and his employees almost two decades after Fischer created his first sticker.

Questions for Discussion

1. How does being a risk-taker help Fischer in his business activities?
2. If you were a small business owner, would you consider sharing the company's financial data with employees? Explain your reasoning.

Sources: "All About StickerGiant," <https://www.stickergiant.com>, accessed May 29, 2017; Bo Burlingham, "Forbes Small Giants 2017: America's Best Small Companies," *Forbes*, <http://www.forbes.com>, May 9, 2017; Karsten Strauss, "Making Money and Breaking Records in the Sticker Business," *Forbes*, <http://www.forbes.com>, January 26, 2016; Emilie Rusch, "StickerGiant Does Big Business in Tiny Town of Hygiene," *Denver Post*, April 19, 2016, <http://www.denverpost.com>; Eric Peterson, "StickerGiant," *Company Week*, <https://companyweek.com>, September 5, 2016.

A number of outstanding managers and noted academics are beginning to emphasize a fifth factor of production—knowledge. **Knowledge** refers to the combined talents and skills of the workforce and has become a primary driver of economic growth. Today's competitive environment places a premium on knowledge and learning over physical resources. Recent statistics suggest that the number of U.S. **knowledge workers** has doubled over the last 30 years, with an estimated 2 million knowledge job openings annually. Despite the fact that many "routine" jobs have been replaced by automation over the last decade or outsourced to other countries, technology has actually created more jobs that require knowledge and

cognitive skills.⁶

CONCEPT CHECK



1. Explain the concepts of revenue, costs, and profit.
2. What are the five factors of production?
3. What is the role of an entrepreneur in society?

1.2

Understanding the Business Environment

2. What are the sectors of the business environment, and how do changes in them influence business decisions?

Businesses do not operate in a vacuum but rather in a dynamic environment that has a direct influence on how they operate and whether they will achieve their objectives. This external business environment is composed of numerous outside organizations and forces that we can group into seven key subenvironments, as **Exhibit 1.4** illustrates: economic, political and legal, demographic, social, competitive, global, and technological. Each of these sectors creates a unique set of challenges and opportunities for businesses.

Business owners and managers have a great deal of control over the internal environment of business, which covers day-to-day decisions. They choose the supplies they purchase, which employees they hire, the products they sell, and where they sell those products. They use their skills and resources to create goods and services that will satisfy existing and prospective customers. However, the external environmental conditions that affect a business are generally beyond the control of management and change constantly. To compete successfully, business owners and managers must continuously study the environment and adapt their businesses accordingly.

Other forces, such as natural disasters, can also have a major impact on businesses. While still in the rebuilding stage after Hurricane Katrina hit in 2005, the U.S. Gulf Coast suffered another disaster in April 2010 as a result of an explosion on the Deepwater Horizon oil-rig, which killed 11 workers and sent more than 3 million barrels of oil into the Gulf of Mexico. This event, which played out for more than 87 days, severely affected the environment, businesses, tourism, and people's livelihoods. Global oil conglomerate BP, which was responsible for the oil spill, has spent more than \$60 billion in response to the disaster and cleanup. Seven years after the explosion, tourism and other businesses are slowly recovering, although scientists are not certain about the long-term environmental consequences of the oil spill.⁷

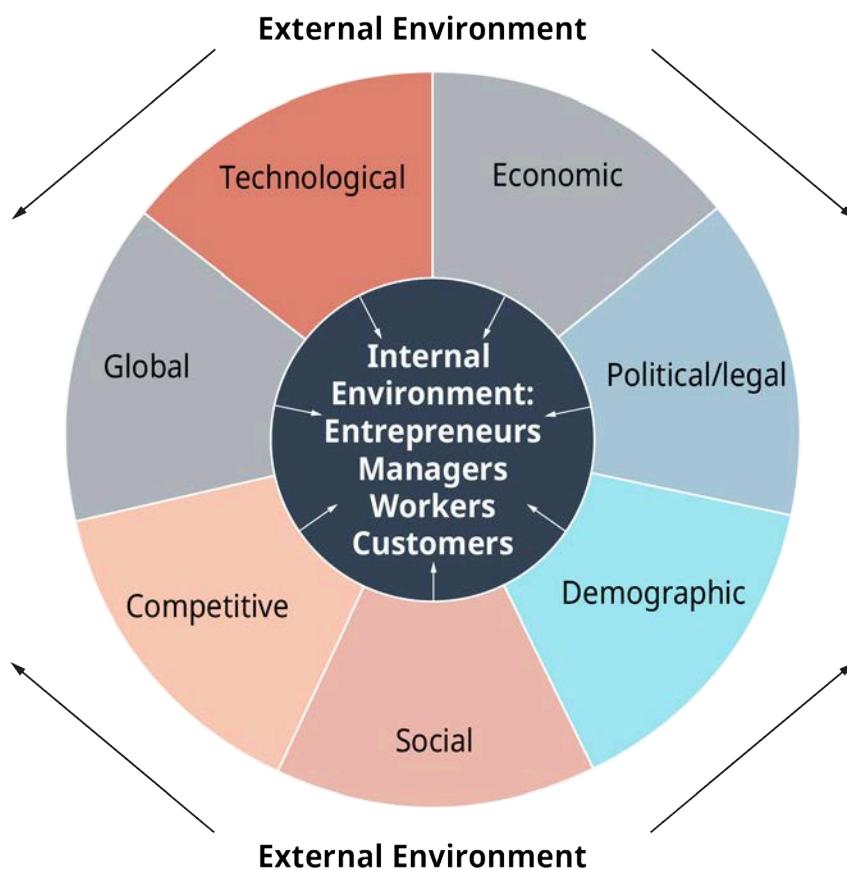


Exhibit 1.4 The Dynamic Business Environment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

No one business is large or powerful enough to create major changes in the external environment. Thus, managers are primarily adapters to, rather than agents of, change. Global competition is basically an uncontrollable element in the external environment. In some situations, however, a firm can influence external events through its strategies. For example, major U.S. pharmaceutical companies have been successful in getting the Food and Drug Administration (FDA) to speed up the approval process for new drugs.⁸ In recent years, the five largest companies in the S&P Index—Google, Facebook, Amazon, Microsoft, and Apple—have spent close to \$50 million on lobbying activities in the nation's capital in an effort to help policy makers understand the tech industry and the importance of innovation and an “open” internet.⁹ Let’s now take a brief look at these varied environmental influences.

Economic Influences

This category is one of the most important external influences on businesses. Fluctuations in the level of economic activity create business cycles that affect businesses and individuals in many ways. When the economy is growing, for example, unemployment rates are low, and income levels rise. Inflation and interest rates are other areas that change according to economic activity. Through the policies it sets, such as taxes and interest rate levels, a government attempts to stimulate or curtail the level of economic activity. In addition, the forces of supply and demand determine how prices and quantities of goods and services behave in a free market.

Political and Legal Influences

The political climate of a country is another critical factor for managers to consider in day-to-day business operations. The amount of government activity, the types of laws it passes, and the general political stability of a government are three components of political climate. For example, a multinational company such as General Electric will evaluate the political climate of a country before deciding to locate a plant there. Is the government stable, or might a coup disrupt the country? How restrictive are the regulations for foreign businesses, including foreign ownership of business property and taxation? Import tariffs, quotas, and export restrictions also must be taken into account.

In the United States, laws passed by Congress and the many regulatory agencies cover such areas as competition, minimum wages, environmental protection, worker safety, and copyrights and patents. For example, Congress passed the Telecommunications Act of 1996 to deregulate the telecommunications industry. As a result, competition increased and new opportunities arose as traditional boundaries between service providers blurred. Today the dramatic growth in mobile technology has changed the focus of telecommunications, which now faces challenges related to broadband access and speed, content streaming, and much-needed improvements in network infrastructure to address ever-increasing data transmissions.¹⁰

Federal agencies play a significant role in business operations. When Pfizer wants to bring a new medication for heart disease to market, it must follow the procedures set by the Food and Drug Administration for testing and clinical trials and secure FDA approval. Before issuing stock, Pfizer must register the securities with the Securities and Exchange Commission. The Federal Trade Commission will penalize Pfizer if its advertisements promoting the drug's benefits are misleading. These are just a few ways the political and legal environment affect business decisions.

States and local governments also exert control over businesses—imposing taxes, issuing corporate charters and business licenses, setting zoning ordinances, and similar regulations. We discuss the legal environment in greater detail in a separate appendix.

Demographic Factors

Demographic factors are an uncontrollable factor in the business environment and extremely important to managers. **Demography** is the study of people's vital statistics, such as their age, gender, race and ethnicity, and location. Demographics help companies define the markets for their products and also determine the size and composition of the workforce. You'll encounter demographics as you continue your study of business.

Demographics are at the heart of many business decisions. Businesses today must deal with the unique shopping preferences of different generations, which each require marketing approaches and goods and services targeted to their needs. For example, the more than 75 million members of the millennial generation were born between 1981 and 1997. In 2017 they surpassed baby boomers as America's largest generation.¹¹ The marketing impact of millennials continues to be immense. These are technologically savvy and prosperous young people, with hundreds of billions of dollars to spend. And spend they do—freely, even though they haven't yet reached their peak income and spending years.¹² Other age groups, such as Generation X—people born between 1965 and 1980—and the baby boomers—born between 1946 and 1964—have their own spending patterns. Many boomers nearing retirement have money and are willing to spend it on their health, their comforts, leisure pursuits, and cars. As the population ages, businesses are offering more products that appeal to middle-aged and senior markets.¹³

In addition, minorities represent more than 38 percent of the total population, with immigration bringing millions of new residents to the country over the past several decades. By 2060 the U.S. Census Bureau

projects the minority population to increase to 56 percent of the total U.S. population.¹⁴ Companies recognize the value of hiring a diverse workforce that reflects our society. Minorities' buying power has increased significantly as well, and companies are developing products and marketing campaigns that target different ethnic groups.

Social Factors

Social factors—our attitudes, values, ethics, and lifestyles—influence what, how, where, and when people purchase products or services. They are difficult to predict, define, and measure because they can be very subjective. They also change as people move through different life stages. People of all ages have a broader range of interests, defying traditional consumer profiles. They also experience a “poverty of time” and seek ways to gain more control over their time. Changing roles have brought more women into the workforce. This development is increasing family incomes, heightening demand for time-saving goods and services, changing family shopping patterns, and impacting individuals’ ability to achieve a work-life balance. In addition, a renewed emphasis on ethical behavior within organizations at all levels of the company has managers and employees alike searching for the right approach when it comes to gender inequality, sexual harassment, and other social behaviors that impact the potential for a business’s continued success.

MANAGING CHANGE



Balancing Comes Easy at H&R Block

In an industry driven by deadlines and details, it's hard to imagine striking a balance between work and everyday life for full-time employees and seasonal staff. Fortunately, the management team at H&R Block not only believes in maintaining a strong culture, it also tries to offer flexibility to its more than 70,000 employees and seasonal workers in 12,000 retail offices worldwide.

Based in Kansas City, Missouri, and built on a culture of providing exceptional customer service, H&R Block was recently named the top U.S. business with the best work-life balance by online job search site Indeed. Analyzing more than 10 million company reviews by employees, Indeed researchers identified the top 20 firms with the best work-life balance. H&R Block headed the 2017 list, followed by mortgage lender Network Capital Funding Corporation, fast food chain In-N-Out Burger, Texas food retailer H-E-B, and health services company Kaiser Permanente, among others.

According to Paul Wolfe, Indeed's senior vice president of human resources, empathy on the part of organizations is a key factor in helping employees achieve balance. Wolfe says companies that demonstrate empathy and work diligently to provide personal time for all employees tend to take the top spots on the work-life balance list. “Comments we have seen from employee reviews for these companies indicate ‘fair’ and ‘flexible work environments,’” he says. Surprisingly, none of the tech companies known for their generous work perks made the top 20 list in 2017.

In this 24/7 world, when no one is far from a text or tweet, finding time for both family and work can be difficult, especially in the tax services industry, which is so schedule driven for a good part of the year. Making a commitment to help workers achieve a healthy work-life balance not only helps its employees, but it also helps H&R Block retain workers in a tight labor market where individuals continue to have

choices when it comes to where and for whom they want to work.

Questions for Discussion

1. How does management's support of employee work-life balance help the company's bottom line?
2. What can other organizations learn from H&R Block when it comes to offering employee perks that encourage personal time for workers even during the busy tax season?

Sources: "Career Opportunities," <https://www.hrbblock.com>, accessed May 25, 2017; "About Us," <http://newsroom.hrbblock.com>, accessed May 25, 2017; Abigail Hess, "The 20 Best Companies for Work-Life Balance," *CNBC*, <http://www.cnbc.com>, May 4, 2017; Kristen Bahler, "The 20 Best Companies for Work-Life Balance," *Money*, <http://time.com>, April 20, 2017; Rachel Ritlop, "3 Benefits Companies Can Provide to Boost Work-Life Balance," *Forbes*, <http://www.forbes.com>, January 30, 2017.

Technology

The application of technology can stimulate growth under capitalism or any other economic system.

Technology is the application of science and engineering skills and knowledge to solve production and organizational problems. New equipment and software that improve productivity and reduce costs can be among a company's most valuable assets. **Productivity** is the amount of goods and services one worker can produce. Our ability as a nation to maintain and build wealth depends in large part on the speed and effectiveness with which we use technology—to invent and adapt more efficient equipment to improve manufacturing productivity, to develop new products, and to process information and make it instantly available across the organization and to suppliers and customers.

Many U.S. businesses, large and small, use technology to create change, improve efficiencies, and streamline operations. For example, advances in cloud computing provide businesses with the ability to access and store data without running applications or programs housed on a physical computer or server in their offices. Such applications and programs can now be accessed through the internet. Mobile technology allows businesses to communicate with employees, customers, suppliers, and others at the swipe of a tablet or smartphone screen. Robots help businesses automate repetitive tasks that free up workers to focus on more knowledge-based tasks critical to business operations.¹⁵

CONCEPT CHECK



1. Define the components of the internal and the external business environments.
2. What factors within the economic environment affect businesses?
3. Why do demographic shifts and technological developments create both challenges and new opportunities for business?

1.3

How Business and Economics Work

3. What are the primary features of the world's economic systems, and how are the three sectors of the U.S. economy linked?

A business's success depends in part on the economic systems of the countries where it is located and where it sells its products. A nation's **economic system** is the combination of policies, laws, and choices made by its government to establish the systems that determine what goods and services are produced and how they are allocated. **Economics** is the study of how a society uses scarce resources to produce and distribute goods and services. The resources of a person, a firm, or a nation are limited. Hence, economics is the study of choices—what people, firms, or nations choose from among the available resources. Every economy is concerned with what types and amounts of goods and services should be produced, how they should be produced, and for whom. These decisions are made by the marketplace, the government, or both. In the United States, the government and the free-market system together guide the economy.

You probably know more about economics than you realize. Every day, many news stories deal with economic matters: a union wins wage increases at General Motors, the Federal Reserve Board lowers interest rates, Wall Street has a record day, the president proposes a cut in income taxes, consumer spending rises as the economy grows, or retail prices are on the rise, to mention just a few examples.

Global Economic Systems

Businesses and other organizations operate according to the *economic systems* of their home countries. Today the world's major economic systems fall into two broad categories: free market, or capitalism; and planned economies, which include communism and socialism. However, in reality many countries use a mixed market system that incorporates elements from more than one economic system.

The major differentiator among economic systems is whether the government or individuals decide:

- How to allocate limited resources—the factors of production—to individuals and organizations to best satisfy unlimited societal needs
- What goods and services to produce and in what quantities
- How and by whom these goods and services are produced
- How to distribute goods and services to consumers

Managers must understand and adapt to the economic system or systems in which they operate. Companies that do business internationally may discover that they must make changes in production and selling methods to accommodate the economic system of other countries. **Table 1.1** summarizes key factors of the world's economic systems.

The Basic Economic Systems of the World				
	Capitalism	Communism	Socialism	Mixed Economy
Ownership of Business	Businesses are privately owned with minimal government ownership or interference.	Government owns all or most enterprises.	Basic industries such as railroads and utilities are owned by government. Very high taxation as government redistributes income from successful private businesses and entrepreneurs.	Private ownership of land and businesses but government control of some enterprises. The private sector is typically large
Control of Markets	Complete freedom of trade. No or little government control.	Complete government control of markets.	Some markets are controlled, and some are free. Significant central-government planning. State enterprises are managed by bureaucrats. These enterprises are rarely profitable.	Some markets, such as nuclear energy and the post office, are controlled or highly regulated.
Worker Incentives	Strong incentive to work and innovate because profits are retained by owners.	No incentive to work hard or produce quality products.	Private-sector incentives are the same as capitalism, and public-sector incentives are the same as in a planned economy.	Private-sector incentives are the same as capitalism. Limited incentives in the public sector.
Management of Enterprises	Each enterprise is managed by owners or professional managers with little government interference.	Centralized management by the government bureaucracy. Little or no flexibility in decision-making at the factory level.	Significant government planning and regulation. Bureaucrats run government enterprises.	Private-sector management similar to capitalism. Public sector similar to socialism.

Table 1.1

The Basic Economic Systems of the World				
	Capitalism	Communism	Socialism	Mixed Economy
Forecast for 2020	Continued steady growth.	No growth and perhaps disappearance.	Stable with probable slight growth.	Continued growth.
Examples	United States	Cuba, North Korea	Finland, India, Israel	Great Britain, France, Sweden, Canada

Table 1.1

Capitalism

In recent years, more countries have shifted toward free-market economic systems and away from planned economies. Sometimes, as was the case of the former East Germany, the transition to capitalism was painful but fairly quick. In other countries, such as Russia, the movement has been characterized by false starts and backsliding. **Capitalism**, also known as the *private enterprise system*, is based on competition in the marketplace and private ownership of the factors of production (resources). In a competitive economic system, a large number of people and businesses buy and sell products freely in the marketplace. In pure capitalism, all the factors of production are owned privately, and the government does not try to set prices or coordinate economic activity.

A capitalist system guarantees certain economic rights: the right to own property, the right to make a profit, the right to make free choices, and the right to compete. The right to own property is central to capitalism. The main incentive in this system is profit, which encourages entrepreneurship. Profit is also necessary for producing goods and services, building manufacturing plants, paying dividends and taxes, and creating jobs. The freedom to choose whether to become an entrepreneur or to work for someone else means that people have the right to decide what they want to do on the basis of their own drive, interest, and training. The government does not create job quotas for each industry or give people tests to determine what they will do.

Competition is good for both businesses and consumers in a capitalist system. It leads to better and more diverse products, keeps prices stable, and increases the efficiency of producers. Companies try to produce their goods and services at the lowest possible cost and sell them at the highest possible price. But when profits are high, more businesses enter the market to seek a share of those profits. The resulting competition among companies tends to lower prices. Companies must then find new ways of operating more efficiently if they are to keep making a profit—and stay in business.



Exhibit 1.5 McDonald's China Since joining the World Trade Organization in 2001, China has continued to embrace tenets of capitalism and grow its economy. China is the world's largest producer of mobile phones, PCs, and tablets, and the country's over one billion people constitute a gargantuan market. The explosion of McDonald's and KFC franchises epitomizes the success of American-style capitalism in China, and Beijing's bid to host the 2022 Winter Olympics is a symbol of economic openness. This McCafe is an example of changing Western products to suit Chinese tastes. This is an example of changing Western products to suit Chinese tastes. *Do you think China's capitalistic trend can continue to thrive under the ruling Chinese Communist Party that opposes workers' rights, free speech, and democracy?* (Credit: Marku Kudjerski/flickr/Attribution 2.0 Generic (CC BY 2.0)

Communism

The complete opposite of capitalism is **communism**. In a communist economic system, the government owns virtually all resources and controls all markets. Economic decision-making is centralized: the government, rather than the competitive forces in the marketplace, decides what will be produced, where it will be produced, how much will be produced, where the raw materials and supplies will come from, who will get the output, and what the prices will be. This form of centralized economic system offers little if any choice to a country's citizens. Early in the 20th century, countries that chose communism, such as the former Soviet Union and China, believed that it would raise their standard of living. In practice, however, the tight controls over most aspects of people's lives, such as what careers they can choose, where they can work, and what they can buy, led to lower productivity. Workers had no reasons to work harder or produce quality goods, because there were no rewards for excellence. Errors in planning and resource allocation led to shortages of even basic items.

These factors were among the reasons for the 1991 collapse of the Soviet Union into multiple independent nations. Recent reforms in Russia, China, and most of the eastern European nations have moved these economies toward more capitalistic, market-oriented systems. North Korea and Cuba are the best remaining examples of communist economic systems. Time will tell whether Cuba takes small steps toward a market economy now that the United States reestablished diplomatic relations with the island country a few years

ago.¹⁶

Socialism

Socialism is an economic system in which the basic industries are owned by the government or by the private sector under strong government control. A socialist state controls critical, large-scale industries such as transportation, communications, and utilities. Smaller businesses and those considered less critical, such as retail, may be privately owned. To varying degrees, the state also determines the goals of businesses, the prices and selection of goods, and the rights of workers. Socialist countries typically provide their citizens with a higher level of services, such as health care and unemployment benefits, than do most capitalist countries. As a result, taxes and unemployment may also be higher in socialist countries. For example, in 2017, the top individual tax rate in France was 45 percent, compared to 39.6 percent in the United States. With both countries electing new presidents in 2017, tax cuts may be a campaign promise that both President Macron and President Trump take on as part of their overall economic agendas in the coming years.¹⁷

Many countries, including the United Kingdom, Denmark, India, and Israel, have socialist systems, but the systems vary from country to country. In Denmark, for example, most businesses are privately owned and operated, but two-thirds of the population is sustained by the state through government welfare programs.

Mixed Economic Systems

Pure capitalism and communism are extremes; real-world economies fall somewhere between the two. The U.S. economy leans toward pure capitalism, but it uses government policies to promote economic stability and growth. Also, through policies and laws, the government transfers money to the poor, the unemployed, and the elderly or disabled. American capitalism has produced some very powerful organizations in the form of large corporations, such as General Motors and Microsoft. To protect smaller firms and entrepreneurs, the government has passed legislation that requires that the giants compete fairly against weaker competitors.

Canada, Sweden, and the UK, among others, are also called **mixed economies**; that is, they use more than one economic system. Sometimes, the government is basically socialist and owns basic industries. In Canada, for example, the government owns the communications, transportation, and utilities industries, as well as some of the natural-resource industries. It also provides health care to its citizens. But most other activity is carried on by private enterprise, as in a capitalist system. In 2016, UK citizens voted for Britain to leave the European Union, a move that will take two or more years to finalize. It is too early to tell what impact the Brexit decision will have on the UK economy and other economies around the world.¹⁸

The few factors of production owned by the government in a mixed economy include some public lands, the postal service, and some water resources. But the government is extensively involved in the economic system through taxing, spending, and welfare activities. The economy is also mixed in the sense that the country tries to achieve many social goals—income redistribution and retirement pensions, for example—that may not be attempted in purely capitalist systems.

Macroeconomics and Microeconomics

The state of the economy affects both people and businesses. How you spend your money (or save it) is a personal economic decision. Whether you continue in school and whether you work part-time are also economic decisions. Every business also operates within the economy. Based on their economic expectations, businesses decide what products to produce, how to price them, how many people to employ, how much to

pay these employees, how much to expand the business, and so on.

Economics has two main subareas. **Macroeconomics** is the study of the economy as a whole. It looks at *aggregate* data for large groups of people, companies, or products considered as a whole. In contrast, **microeconomics** focuses on individual parts of the economy, such as households or firms.

Both *macroeconomics* and *microeconomics* offer a valuable outlook on the economy. For example, Ford might use both to decide whether to introduce a new line of vehicles. The company would consider such macroeconomic factors as the national level of personal income, the unemployment rate, interest rates, fuel costs, and the national level of sales of new vehicles. From a microeconomic viewpoint, Ford would judge consumer demand for new vehicles versus the existing supply, competing models, labor and material costs and availability, and current prices and sales incentives.

Economics as a Circular Flow

Another way to see how the sectors of the economy interact is to examine the **circular flow** of inputs and outputs among households, businesses, and governments as shown in [Exhibit 1.6](#). Let's review the exchanges by following the red circle around the inside of the diagram. Households provide inputs (natural resources, labor, capital, entrepreneurship, knowledge) to businesses, which convert these inputs into outputs (goods and services) for consumers. In return, households receive income from rent, wages, interest, and ownership profits (blue circle). Businesses receive revenue from consumer purchases of goods and services.

The other important exchange in [Exhibit 1.6](#) takes place between governments (federal, state, and local) and both households and businesses. Governments supply many types of publicly provided goods and services (highways, schools, police, courts, health services, unemployment insurance, social security) that benefit consumers and businesses. Government purchases from businesses also contribute to business revenues. When a construction firm repairs a local stretch of state highway, for example, government pays for the work. As the diagram shows, government receives taxes from households and businesses to complete the flow.

Changes in one flow affect the others. If government raises taxes, households have less to spend on goods and services. Lower consumer spending causes businesses to reduce production, and economic activity declines; unemployment may rise. In contrast, cutting taxes can stimulate economic activity. Keep the circular flow in mind as we continue our study of economics. The way economic sectors interact will become more evident as we explore macroeconomics and microeconomics.

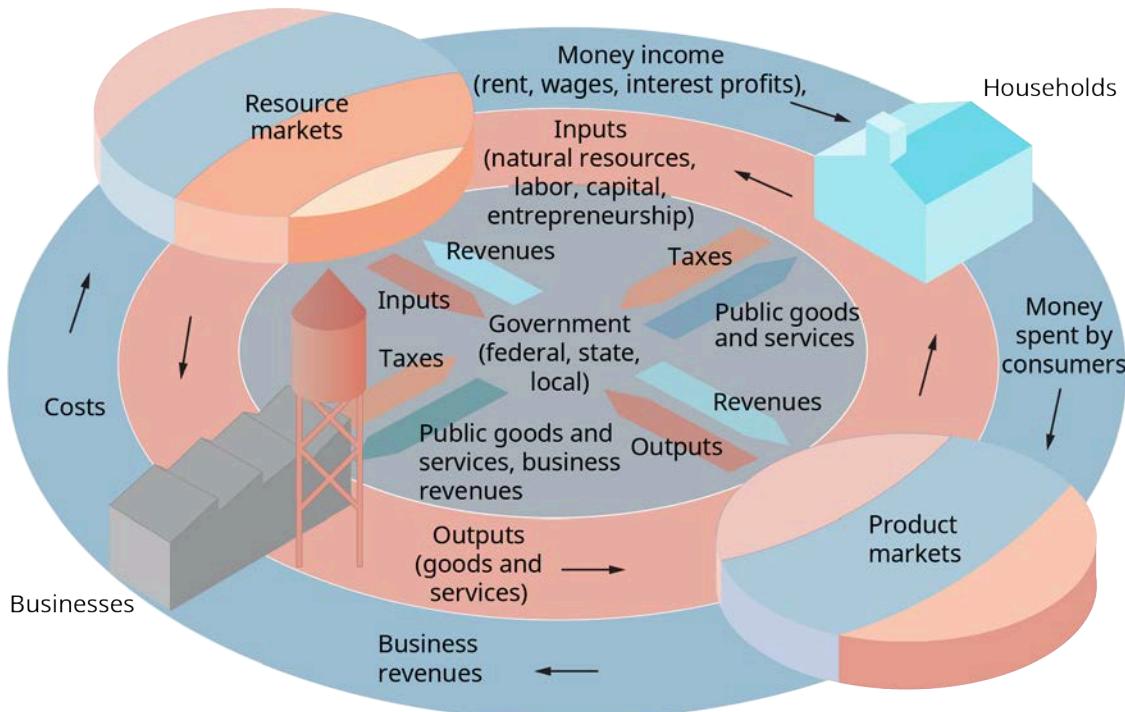


Exhibit 1.6 Economics as a Circular Flow (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK



1. What is economics, and how can you benefit from understanding basic economic concepts?
2. Compare and contrast the world's major economic systems. Why is capitalism growing, communism declining, and socialism still popular?
3. What is the difference between macroeconomics and microeconomics?

1.4 Macroeconomics: The Big Picture

4. How do economic growth, full employment, price stability, and inflation indicate a nation's economic health?

Have you ever looked at CNN's *Headline News* on a mobile device or turned on the radio and heard something like, "Today the Labor Department reported that for the second straight month unemployment declined"?

Statements like this are macroeconomic news. Understanding the national economy and how changes in government policies affect households and businesses is a good place to begin our study of economics.

Let's look first at macroeconomic goals and how they can be met. The United States and most other countries have three main macroeconomic goals: economic growth, full employment, and price stability. A nation's economic well-being depends on carefully defining these goals and choosing the best economic policies for achieving them.

Striving for Economic Growth

Perhaps the most important way to judge a nation's economic health is to look at its production of goods and services. The more the nation produces, the higher its standard of living. An increase in a nation's output of goods and services is **economic growth**.

The most basic measure of economic growth is the **gross domestic product (GDP)**. GDP is the total market value of all final goods and services produced within a nation's borders each year. The Bureau of Labor Statistics publishes quarterly GDP figures that can be used to compare trends in national output. When GDP rises, the economy is growing.

The rate of growth in real GDP (GDP adjusted for inflation) is also important. Recently, the U.S. economy has been growing at a slow but steady rate of between 3 and 4 percent annually. This growth rate has meant a steady increase in the output of goods and services and relatively low unemployment. When the growth rate slides toward zero, the economy begins to stagnate and decline.

One country that continues to grow more rapidly than most is China, whose GDP has been growing at 6 to 7 percent per year. Today few things in the global marketplace are not or cannot be made in China. The primary contributor to China's rapid growth has been technology. For example, most tablets and laptops are manufactured in China.

The level of economic activity is constantly changing. These upward and downward changes are called **business cycles**. Business cycles vary in length, in how high or low the economy moves, and in how much the economy is affected. Changes in GDP trace the patterns as economic activity expands and contracts. An increase in business activity results in rising output, income, employment, and prices. Eventually, these all peak, and output, income, and employment decline. A decline in GDP that lasts for two consecutive quarters (each a three-month period) is called a **recession**. It is followed by a recovery period when economic activity once again increases. The most recent recession began in December 2007 and ended in June 2009.

Businesses must monitor and react to the changing phases of business cycles. When the economy is growing, companies often have a difficult time hiring good employees and finding scarce supplies and raw materials. When a recession hits, many firms find they have more capacity than the demand for their goods and services requires. During the most recent recession, many businesses operated at substantially lower than capacity. When plants use only part of their capacity, they operate inefficiently and have higher costs per unit produced. Let's say that Mars Corp. has a huge plant that can produce one million Milky Way candy bars a day, but because of a recession Mars can sell only half a million candy bars a day. The plant uses large, expensive machines. Producing Milky Ways at 50 percent capacity does not efficiently utilize Mars's investment in its plant and equipment.

Keeping People on the Job

Another macroeconomic goal is **full employment**, or having jobs for all who want to and can work. Full employment doesn't actually mean 100 percent employment. Some people choose not to work for personal reasons (attending school, raising children) or are temporarily unemployed while they wait to start a new job. Thus, the government defines full employment as the situation when about 94 to 96 percent of those available to work actually have jobs. During the 2007–2009 recession in the United States, the unemployment rate peaked at 10 percent in October 2009. Today, that rate hovers at about 4 percent.¹⁹

Maintaining low unemployment levels is of concern not just to the United States but also to countries around

the world. For example, high youth unemployment rates (for workers 25 years of age and younger) in Spain, Italy, and Greece continue to cause protests in these European countries as elected officials struggle with how to turn around their respective economies and put more people, particularly young people, back to work. The UK's impending exit from the European Union may also have an effect on unemployment rates, as global companies move jobs out of Britain to central European countries such as Poland.²⁰

Measuring Unemployment

To determine how close we are to full employment, the government measures the **unemployment rate**. This rate indicates the percentage of the total labor force that is not working but is actively looking for work. It excludes "discouraged workers," those not seeking jobs because they think no one will hire them. Each month the U.S. Department of Labor releases statistics on employment. These figures help us understand how well the economy is doing.

Types of Unemployment

Economists classify unemployment into four types: frictional, structural, cyclical, and seasonal. The categories are of small consolation to someone who is unemployed, but they help economists understand the problem of unemployment in our economy.

Frictional unemployment is short-term unemployment that is not related to the business cycle. It includes people who are unemployed while waiting to start a better job, those who are reentering the job market, and those entering for the first time, such as new college graduates. This type of unemployment is always present and has little impact on the economy.

Structural unemployment is also unrelated to the business cycle but is involuntary. It is caused by a mismatch between available jobs and the skills of available workers in an industry or a region. For example, if the birthrate declines, fewer teachers will be needed. Or the available workers in an area may lack the skills that employers want. Retraining and skill-building programs are often required to reduce structural unemployment.

Cyclical unemployment, as the name implies, occurs when a downturn in the business cycle reduces the demand for labor throughout the economy. In a long recession, cyclical unemployment is widespread, and even people with good job skills can't find jobs. The government can partly counteract cyclical unemployment with programs that boost the economy.

In the past, cyclical unemployment affected mainly less-skilled workers and those in heavy manufacturing. Typically, they would be rehired when economic growth increased. Since the 1990s, however, competition has forced many American companies to downsize so they can survive in the global marketplace. These job reductions affected workers in all categories, including middle management and other salaried positions. Firms continue to reevaluate workforce requirements and downsize to stay competitive to compete with Asian, European, and other U.S. firms. After a strong rebound from the global recession of 2007–2009, when the auto industry slashed more than 200,000 hourly and salaried workers from their payrolls, the automakers are now taking another close look at the size of their global workforces. For example, as sales steadily rose after the recession, Ford Motor Company's workforce in North America increased by 25 percent over the past five years. As car sales plateaued in 2017, the company recently announced it would cut approximately 10 percent of its global workforce in an effort to reduce costs, boost profits, and increase its stock value for shareholders.²¹

The last type is **seasonal unemployment**, which occurs during specific times of the year in certain industries.

Employees subject to seasonal unemployment include retail workers hired for the holiday shopping season, lettuce pickers in California, and restaurant employees in ski country during the summer.

Keeping Prices Steady

The third macroeconomic goal is to keep overall prices for goods and services fairly steady. The situation in which the average of all prices of goods and services is rising is called **inflation**. Inflation's higher prices reduce **purchasing power**, the value of what money can buy. Purchasing power is a function of two things: inflation and income. If incomes rise at the same rate as inflation, there is no change in purchasing power. If prices go up but income doesn't rise or rises at a slower rate, a given amount of income buys less, and purchasing power falls. For example, if the price of a basket of groceries rises from \$30 to \$40 but your salary remains the same, you can buy only 75 percent as many groceries ($\$30 \div \40) for \$30. Your purchasing power declines by 25 percent ($\$10 \div \40). If incomes rise at a rate faster than inflation, then purchasing power increases. So you can, in fact, have rising purchasing power even if inflation is increasing. Typically, however, inflation rises faster than incomes, leading to a decrease in purchasing power.

Inflation affects both personal and business decisions. When prices are rising, people tend to spend more—before their purchasing power declines further. Businesses that expect inflation often increase their supplies, and people often speed up planned purchases of cars and major appliances.

From the early 2000s to April 2017, inflation in the United States was very low, in the 0.1 to 3.8 percent range; for 2016 it was 1.3 percent. For comparison, in the 1980s, the United States had periods of inflation in the 12 to 13 percent range.²² Some nations have had high double- and even triple-digit inflation in recent years. As of early 2017, the monthly inflation rate in Venezuela was an astounding 741 percent, followed by the African country of South Sudan at 273 percent.²³



Exhibit 1.7 Nespresso Buyers of Nespresso coffee, KitKat chocolate bars, and Purina pet food are paying more for these items as global food giant Nestlé raises prices. Increasing input costs, such as costs of raw materials, have been hard on food businesses, raising the price of production, packaging, and transportation. *How might fluctuations in the producer price index (PPI) affect the consumer price index (CPI) and why?* (Credit: Kārlis Dambrāns/flickr/ Attribution 2.0 Generic (CC BY 2.0))

Types of Inflation

There are two types of inflation. **Demand-pull inflation** occurs when the demand for goods and services is greater than the supply. Would-be buyers have more money to spend than the amount needed to buy available goods and services. Their demand, which exceeds the supply, tends to pull prices up. This situation is sometimes described as “too much money chasing too few goods.” The higher prices lead to greater supply, eventually creating a balance between demand and supply.

Cost-push inflation is triggered by increases in production costs, such as expenses for materials and wages. These increases push up the prices of final goods and services. Wage increases are a major cause of cost-push inflation, creating a “wage-price spiral.” For example, assume the United Auto Workers union negotiates a three-year labor agreement that raises wages 3 percent per year and increases overtime pay. Carmakers will then raise car prices to cover their higher labor costs. Also, the higher wages will give autoworkers more money to buy goods and services, and this increased demand may pull up other prices. Workers in other industries will demand higher wages to keep up with the increased prices, and the cycle will push prices even higher.

How Inflation Is Measured

The rate of inflation is most commonly measured by looking at changes in the **consumer price index (CPI)**, an index of the prices of a “market basket” of goods and services purchased by typical urban consumers. It is published monthly by the Department of Labor. Major components of the CPI, which are weighted by

importance, are food and beverages, clothing, transportation, housing, medical care, recreation, and education. There are special indexes for food and energy. The Department of Labor collects about 80,000 retail price quotes and 5,000 housing rent figures to calculate the CPI.

The CPI sets prices in a base period at 100. The base period, which now is 1982–1984, is chosen for its price stability. Current prices are then expressed as a percentage of prices in the base period. A rise in the CPI means prices are increasing. For example, the CPI was 244.5 in April 2017, meaning that prices more than doubled since the 1982–1984 base period.

Changes in wholesale prices are another important indicator of inflation. The **producer price index (PPI)** measures the prices paid by producers and wholesalers for various commodities, such as raw materials, partially finished goods, and finished products. The PPI, which uses 1982 as its base year, is actually a family of indexes for many different product categories, including crude goods (raw materials), intermediate goods (which become part of finished goods), and finished goods. For example, the PPI for finished goods was 197.7 in April 2017, a 3.9-point increase, and for chemicals was 106.5, up 3.8 points since April 2016. Examples of other PPI indexes include processed foods, lumber, containers, fuels and lubricants, metals, and construction. Because the PPI measures prices paid by producers for raw materials, energy, and other commodities, it may foreshadow subsequent price changes for businesses and consumers.

The Impact of Inflation

Inflation has several negative effects on people and businesses. For one thing, inflation penalizes people who live on fixed incomes. Let's say that a couple receives \$2,000 a month retirement income beginning in 2018. If inflation is 10 percent in 2019, then the couple can buy only about 91 percent ($100 \div 110$) of what they could purchase in 2018. Similarly, inflation hurts savers. As prices rise, the real value, or purchasing power, of a nest egg of savings deteriorates.

CONCEPT CHECK



1. What is a business cycle? How do businesses adapt to periods of contraction and expansion?
2. Why is full employment usually defined as a target percentage below 100 percent?
3. What is the difference between demand-pull and cost-push inflation?

1.5

Achieving Macroeconomic Goals

5. How does the government use monetary policy and fiscal policy to achieve its macroeconomic goals?

To reach macroeconomic goals, countries must often choose among conflicting alternatives. Sometimes political needs override economic needs. For example, bringing inflation under control may call for a politically difficult period of high unemployment and low growth. Or, in an election year, politicians may resist raising taxes to curb inflation. Still, the government must try to guide the economy to a sound balance of growth, employment, and price stability. The two main tools it uses are monetary policy and fiscal policy.

Monetary Policy

Monetary policy refers to a government's programs for controlling the amount of money circulating in the economy and interest rates. Changes in the money supply affect both the level of economic activity and the rate of inflation. The **Federal Reserve System (the Fed)**, the central banking system of the United States, prints money and controls how much of it will be in circulation. The money supply is also controlled by the Fed's regulation of certain bank activities.

When the Fed increases or decreases the amount of money in circulation, it affects interest rates (the cost of borrowing money and the reward for lending it). The Fed can change the interest rate on money it lends to banks to signal the banking system and financial markets that it has changed its monetary policy. These changes have a ripple effect. Banks, in turn, may pass along this change to consumers and businesses that receive loans from the banks. If the cost of borrowing increases, the economy slows because interest rates affect consumer and business decisions to spend or invest. The housing industry, business, and investments react most to changes in interest rates.

As a result of the 2007–2009 recession and the global financial crisis that ensued, the Fed dropped the federal funds rate—the interest rate charged on overnight loans between banks—to 0 percent in December 2008 and kept the rate at zero until December 2015, when it raised the rate to 0.25 percent. This decision marked the first increase in the federal-funds rate since June 2006, when the federal funds rate was 5.25 percent. As the U.S. economy continues to show a slow but steady expansion, the Fed subsequently increased the federal funds rate to a range of 0.75 to 1 percent in March 2017. As expected, this change has a ripple effect: the regional Federal Reserve Banks increase the discount rate they charge commercial banks for short-term loans, many commercial banks raise the interest rates they charge their customers, and credit card companies increase the annual percentage rate (APR) they charge consumers on their credit card balances.²⁴

As you can see, the Fed can use monetary policy to contract or expand the economy. With **contractionary policy**, the Fed restricts, or tightens, the money supply by selling government securities or raising interest rates. The result is slower economic growth and higher unemployment. Thus, contractionary policy reduces spending and, ultimately, lowers inflation. With **expansionary policy**, the Fed increases, or loosens, growth in the money supply. An expansionary policy stimulates the economy. Interest rates decline, so business and consumer spending go up. Unemployment rates drop as businesses expand. But increasing the money supply also has a negative side: more spending pushes prices up, increasing the inflation rate.