Chapter 1: The U.S. Business Environment

Chapter Overview

Many students come to an introduction to business class not quite sure what it's all about. The course has something for everyone, from those who have been in the business world a while to those just getting started. As the book unfolds, you'll develop an understanding of the foundations of business and will be able to apply what you already know (or what you are starting to learn) about business to many aspects of the course.

This first chapter dives right into the world of business, explaining what business is, what its main goals and functions are, and how the external environments of business affect the success and failure of any organization. The chapter also:

- Defines the nature of U.S. business, describes the external environments of business, and discusses how these environments affect the success or failure of organizations.
- Describes global economic systems according to the means by which they control the factors of production.
- Shows how markets, demand, and supply affect resource distribution in the United States.
- Discusses the elements of private enterprise and the degrees of competition in the U.S. economic system.
- Explains the importance of the economic environment to business and identifies the factors used to evaluate the performance of an economic system.

Learning Objectives

1. Define the nature of U.S. business, describe the external environments of business, and discuss how these environments affect the success or failure of organizations.

2. Describe the different types of global economic systems according to the means by which they control the factors of production.

3. Show how markets, demand, and supply affect resource distribution in the United States, identify the elements of private enterprise, and explain the various degrees of competition in the U.S. economic system.

4. Explain the importance of the economic environment to business and identify the factors used to evaluate the performance of an economic system.

CHAPTER OUTLINE

Learning Objective 1-1:

Define the nature of U.S. business, describe the external environments of business and discuss how these environments affect the success or failure of organizations.

Business and Profit

A **business** is an organization that provides goods and services to earn profits. **Profits** are the difference between a business's revenues and expenses.

1. **Consumer Choice and Demand:** In a capitalistic system like that of the United States, consumers have freedom of choice. In turn, businesses must take into account consumer demand as shown through wants and needs in their pursuit of profits.

2. **Opportunity and Enterprise:** Opportunity involves goods or services that consumers need or want, especially if no one else is supplying them or if existing businesses are doing so inefficiently or incompletely.

3. **The Benefits of Business:** Businesses produce most of the goods and services consumed, employ most working people, create new innovations, and provide opportunities for new businesses to serve as suppliers. Further, businesses contribute to the quality of life and the standard of living in a society. Businesses provide incomes, taxes to support government, support to charities and community leadership.

The External Environments of Business

The **external environment** consists of everything outside an organization's boundaries that might affect it. Managers must understand their environment to understand how to operate and compete within it. Businesses can also influence their environments. Six major dimensions of the external environment are:

1. **Domestic Business Environment.** The domestic business environment refers to the environment in which a firm conducts its operations and derives its revenues. It includes customers, suppliers, and competitors.

2. **Global Business Environment.** The global business environment refers to the international forces that affect a business; various factors including international trade agreements, international economic conditions, and political unrest affect the global environment at both the general and immediate levels. International market opportunities, suppliers, cultures, competitors, and currency values can impact any business.

3. **Technological Environment.** The technological environment generally includes all the ways by which firms create value for their constituents; technology includes human knowledge, work methods, physical equipment, electronics and telecommunications, and various processing systems used to perform business activities.

4. **Political-Legal Environment.** The political-legal environment reflects the relationship between business and government, usually in the form of government regulation of business.

5. **Sociocultural Environment.** The sociocultural environment includes the customs, mores, values, and demographic characteristics of the society in which an organization functions.

6. **Economic Environment.** The economic environment refers to relevant conditions that exist in the economic system in which a company operates.

Learning Objective 1-2:

Describe the different types of global economic systems according to the means by which they control the factors of production.

Economic System

An **economic system** is a nation's system for allocating its resources among its individual citizens and organizations.

A. Factors of Production

A basic difference between economic systems is the way in which a system manages its factors of production, the resources that a country's businesses use to produce goods and services. Economists focus on five factors of production:

1. **Labor:** The human resource element in businesses, labor includes the physical and intellectual contributions people make while engaged in economic production.

2. **Capital:** The financial resources needed to operate an enterprise are known as capital.

3. **Entrepreneurs:** An entrepreneur is an individual who accepts the risks and opportunities entailed in creating and operating a new business.

4. **Physical Resources:** The tangible things that organizations use to conduct their business are physical resources and can include raw materials, offices, production facilities, supplies, and computers.

5. **Information Resources:** Businesses rely on information resources, such as market forecasts, the specialized knowledge of people, and economic data.

B. Types of Economic Systems

Economic systems vary, depending on how the factors of production are managed.

1. **Planned Economies**: These systems rely on partial or total government control of all or most of the factors of production and allocation decisions. With **communism**—as currently operating in North Korea—all sources of production are owned and operated by

the government.

2. **Market Economies**: Producers and consumers control production and allocation decisions through supply and demand. The political basis of a market economy is **capitalism,** which allows the private ownership of the factors of production and encourages entrepreneurship by offering profits as incentives. The economic basis is the operation of demand and supply.

3. **Mixed Market Economies**: This type of economy features characteristics of both planned and market economies; many countries are moving from planned systems to mixed market systems through **privatization,** which involves the transformation of government-controlled businesses into privately owned enterprises. In the partially planned system called **socialism,** the government owns and operates selected major industries. Many Western European countries, including England and France, allow free market operations in most economic areas but keep government control of others, such as health care. The United States currently is wrestling with who should control health care for the portion of the population that is not eligible (by age) for Medicare.

Learning Objective 1-3

Show how markets, demand, and supply affect resource distribution in the United States, identify the elements of private enterprise, and explain the various degrees of competition in the U.S. economic system.

The Economics of Market Systems

Understanding the complex nature of the U.S. economic system is essential to understanding the environment in which U.S. businesses operate. Market systems allow businesses the flexibility to decide what to produce, how much to produce, and what price to charge; customers are a driving force in market systems because they decide what to buy and at what price. Demand and supply are the predominant forces that guide decisions about what to buy and what to sell.

A. Demand and Supply in a Market Economy

Billions of exchanges take place every day between businesses and individuals; between businesses; and among individuals, businesses, and governments. Exchanges conducted in one area often affect exchanges elsewhere.

1. The Laws of Demand and Supply: **Demand** is the willingness and ability of buyers to purchase a product; **supply** is the willingness and ability of producers to offer a good or service for sale. The **law of demand** states that buyers will purchase more of a product as its price drops; the **law of supply** states that producers will offer more of a product for sale as its price increases.

   a. The Demand and Supply Schedule: The **demand** and **supply schedule** indicates how much of a product will be sold at various prices. Generally speaking, the more consumers are willing to pay for a good, the more producers are likely to divert resources to make more of the good. Conversely, as the price at which consumers are willing to pay for a product falls, production becomes less profitable and producers cut back on production to divert resources to more profitable areas.

b. Demand and Supply Curves: A **demand curve** shows how many products will be demanded at different prices; a **supply curve** shows how many products will be supplied at various prices. The point at which the curves intersect is the **market price** (or **equilibrium price**).

c. Surpluses and Shortages: With a **surplus,** the quantity supplied exceeds the quantity demanded; quantity demanded exceeds quantity supplied with a **shortage.** Businesses should seek the ideal combination of price charged and quantity supplied so as to maximize profits, maintain goodwill among customers, and discourage competition.

B. Private Enterprise and Competition in a Market Economy

Individuals pursue their own interests with minimal government restriction in a **private enterprise** system; such a system requires:

- **Private property rights—**the ability of individuals to own resources
- **Freedom of choice**—the ability to choose where to work and what to buy
- **Profits**—the ability to take risk to earn profit, and
- **Competition—**the ability to compete for customers and scarce resources. Competition occurs when two or more businesses vie for the same resources or customers.

1. **Degrees of Competition.** Economists have identified four degrees of competition in a private enterprise system:

a. **Perfect Competition.** Many small firms exist in an industry; no single firm is powerful enough to influence price.

b. **Monopolistic Competition.** Many sellers of all sizes, but also many buyers exist, so sellers focus on numerous differentiation strategies, such as brand names, design, and advertising.

c. **Oligopoly.** An industry has only a handful of sellers; market entry is difficult because large capital investment is needed. Sellers tend to be large.

d. **Monopoly**. An industry or market has only one producer; that producer enjoys complete control over price. Utility companies are natural monopolies, industries in which one company can most efficiently supply all needed goods or services. Duplicate facilities would be wasteful.

Learning Objective 1-4

Explain the importance of the economic environment to business and identify the factors used to evaluate the performance of an economic system.

Economic Indicators

A. Economic Indicators

These statistics show whether an economic system is strengthening, weakening, or remaining stable.

1. **Economic Growth, Aggregate Output, and Standard of Living.** The business cycle is the pattern of short-term expansions and contractions in an economy; one important use of economic measures is to help governments and businesses understand where in the business cycle they currently are. **Aggregate output** is the total quantity of goods and services produced by an economic system during a given period. Simply put, an increase in aggregate output is growth. **Standard of living** refers to the total quantity and quality of goods and services that can be purchased with the currency used in an economic system; standard of living increases when the quantity of goods and services increases, and the economic system provides more of the goods and services people want.

2. **Gross Domestic Product (GDP):** The **GDP** is the total value of all goods and services produced within a given period through *domestic* factors of production; GDP is a measurement of aggregate output. If GDP is going up, aggregate output is going up; if aggregate output is going up, the nation is experiencing economic growth. **Gross national product (GNP)** refers to the total value of all goods and services produced by a national economy within a given period regardless of where the factors of production are located.

    a. **Real Growth Rate:** Real growth depends on output increasing at a faster rate than population; the real growth rate in 2015 of the U.S. economic system was 2.4 percent while the population grew at a rate of 0.70 percent, thus indicating the real growth rate is modest.

    b. **GDP per Capita:** GDP per capita means GDP per person. GDP divided by total population equals GDP per capita. It is a better measure than GDP itself of the economic well-being of the average person.

    c. **Real GDP:** Real GDP means that GDP has been adjusted to account for changes in currency values and price changes. Nominal GDP is GDP measured in current dollars or with all components valued at current prices, with no adjustments made.

    d. **Purchasing Power Parity:** Purchasing power parity is the principle that exchange rates are set so that the prices of similar products in different countries are about the same. It quantifies what people can actually buy with the financial resources allocated to them by their respective economic systems; it gives a better sense of standards of living around the world.

3. **Productivity:** Productivity compares how much a system produces with the resources needed to produce it; increases in productivity yield increases in the standard of living.

   a. **Balance of Trade:** A country's balance of trade is the economic value of all the products that it exports minus the economic value of its imported products. A *positive* balance results when the value of a country's exports is greater than its imports; that is, more money is flowing into the country as a result of exporting. A *negative* balance results when a country imports more than it exports.

   b. **National Debt:** A country's **national debt** is the amount of money that is owed by the government to creditors.

B. Economic Stability

Stability results when the amount of money available in an economic system and the quantity of goods and services produced in it are growing at about the same rate.

1. **Inflation**. Inflation occurs when widespread price increases plague an economic system; the amount of money in the economic system exceeds the amount of actual output. Inflation can be measured by the **consumer price index (CPI),** which weighs prices of typical products purchased by consumers living in urban areas. Inflation rate equals Change in price index/Initial price index of 100.

2. **Unemployment.** Unemployment is the level of joblessness among people actively seeking work in an economic system; when unemployment is high, a surplus of available workers exists. When unemployment is low, there is a shortage of labor available for businesses to hire.

   Unemployment is sometimes a symptom of a **recession,** when aggregate output declines, or of a **depression,** a prolonged and deep recession. For example, during downturns in the business cycle people in different sectors may lose their jobs at the same time. As a result, overall income and spending may decline to the extent that businesses begin to implement cost saving measures—including reduction in force (downsizing), leading to more unemployment. In early 2010, during the Great Recession, unemployment in the U.S. was 10.2 percent. By November 2011, it was 8.7 percent. By the end of 2016, it was 4.9 percent.

3. **Recession and Depression.** Aggregate output is measured to determine whether an economy is going through a recession. Governments and economists define a **recession** as a period during which aggregate output, as measured by real GDP, declines. The U.S. economy went into a recession in 2008 and many economists agree that we began to emerge in 2011. A prolonged and deep recession is a **depression**.

C. Managing the U.S. Economy

The government manages the U.S. economic system through both fiscal and monetary policies. **Fiscal policies** manage the collection and spending of revenues; changes in tax rates can function as fiscal policies. **Monetary policies** focus on controlling the size of the nation's money supply; the government can influence banks to lend money and can influence the supply of money through stimulus packages. **Stabilization policy** is made up of both fiscal and monetary policies; the goal is to smooth out fluctuations in output and unemployment and to stabilize prices.

