Chapter 3
Economic Environment of Business

3.1 Economic Wants
3.2 Economic Systems
3.3 Fundamentals of Capitalism
3.4 Managing the Economy

REALITY CHECK

Hard Work Pays Off

Juan Gonzales grew up in a small Mexican village. His parents were “dirt-poor shopkeepers,” as he would often say, but Juan’s dad was intent on going to America. And that’s what the family did when Juan was 19. They moved to a large village in the state of New Mexico.

Upon arrival his parents bought a small neighborhood grocery store that had a large backyard. Juan entered a technical college where he learned about agricultural methods. One day after graduation his father said, “Join me in running the store, Juan. Maybe together we can expand with this growing neighborhood.” Juan smiled and told his dad he would use the large backyard and his new knowledge to experiment with raising and selling vegetables. Within a year, customers from other neighborhoods were stopping by the Gonzaleses’ store to buy Juan’s fresh produce.

By the second year, the family decided to expand the store and move to a nearby shopping area. Juan’s dad had already bought a farm to expand the popular vegetable department and to add a homegrown-fruit department as well. The store would now be called the Gonzales Fruit and Vegetable Market. Within a short time, the store was prospering. Like so many people before them, another family of motivated and hardworking immigrants had succeeded in a country known for its prosperous economic system. The Gonzales family had become an active part of the country’s growing economy.
3.1 Economic Wants

Goals
- Describe economic concepts that apply to satisfying economic wants.
- Explain the role of capital formation in an economy.

Terms
- economics
- economic wants
- noneconomic wants
- utility
- producer
- factors of production
- natural resources
- labor
- human capital
- capital goods
- capital formation
- consumer goods and services

All societies face the problem of trying to satisfy the wants of their citizens for goods and services. Although all societies share this problem, different societies developed different systems for producing and using goods and services. The body of knowledge that relates to producing and using goods and services that satisfy human wants is called economics.

At the beginning of this chapter, you will study the concepts that are essential to understanding any economic system. You will then learn about the world’s economic systems, along with economic-political systems. The chapter concludes with fundamentals of capitalism and factors related to economic growth.

Satisfying Our Economic Wants

Businesses help to make the economic system work by producing and distributing the particular goods and services that people want. A good place to begin the study of economics is with the two broad categories of wants found throughout an economic system: economic wants and noneconomic wants.

People have many wants. The economic system, however, operates on the basis of economic wants—the desire for scarce material goods and services. People want material goods, such as clothing, housing, and cars. They also want services, such as hair care, medical attention, and public transportation. Items such as these are scarce because no economic system has the resources to satisfy all the wants of all people for all material goods and services. People also have noneconomic wants. Noneconomic wants are desires for nonmaterial things that are not scarce, such as air, sunshine, friendship, and happiness.

The goods and services that people want have to be produced. Clothes must be made. Homes must be built. Personal services must be supplied. And as you learned in the opening scenario, the Gonzales family expects their customers to want fruit, vegetables, and other basic foods.

Utility

Utility is the ability of a good or a service to satisfy a want. In other words, a good or a service that has utility is a useful good or service. Something is not useful,
however, unless it is available for use in the right form and place and at the right
time. As a result, four common types of utility exist: form, place, time, and posses-
sion. Definitions of the four types of utility, with examples, appear in Figure 3-1.

Anyone who creates utility is a **producer**. Producers are entitled to a reward
for the usefulness that they add to a good or service. Hairstylists are entitled to
a reward for the usefulness of their services. The price you pay for a pen includes
a reward for the manufacturer who made the pen, the shipping company that
delivered it to the merchant, and the retailer who made it possible for you to buy
the pen at the time you wanted it.

**FACTORS OF PRODUCTION**

In creating useful goods and services, a producer uses four basic resources. These
resources, called **factors of production**, are land (natural resources), labor, capital
goods, and entrepreneurship.

**NATURAL RESOURCES** The extent to which a country is able to produce goods
and services is, in part, determined by the natural resources that its land pro-
vides. **Natural resources** are anything provided by nature that affects the pro-
ductive ability of a country. The productive ability of the United States, for
example, depends on its fertile soil, minerals, water and timber resources,
and mild climate.

**LABOR** Labor is the human effort, either physical or mental, that goes into the
production of goods and services. In today’s world of technology and special
equipment such as computers, physical effort is much less important than men-
tal effort—knowing what tasks to complete and how to complete them. A part
of labor is **human capital**, the accumulated knowledge and skills of human
beings—the total value of each person’s education and acquired skills. In a highly

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**FIGURE 3-1  Satisfying wants involves four common types of utility.**

<table>
<thead>
<tr>
<th>Types of Economic Utility</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FORM UTILITY</strong></td>
</tr>
<tr>
<td>Created by changes in the form or shape of a product to make it useful.</td>
</tr>
<tr>
<td>(Form utility usually applies only to goods and not to services.)</td>
</tr>
<tr>
<td>Example: Is the swimsuit you desire to buy available in a particular fabric and style?</td>
</tr>
<tr>
<td><strong>PLACE UTILITY</strong></td>
</tr>
<tr>
<td>Created by having a good or service at the place where it is needed or wanted.</td>
</tr>
<tr>
<td>Example: Is the swimsuit you desire available in a nearby store where it can be purchased?</td>
</tr>
<tr>
<td><strong>TIME UTILITY</strong></td>
</tr>
<tr>
<td>Created when a product or service is available when it is needed or wanted.</td>
</tr>
<tr>
<td>Example: Is the store open when you are ready to buy and use your swimsuit?</td>
</tr>
<tr>
<td><strong>POSSESSION UTILITY</strong></td>
</tr>
<tr>
<td>Created when ownership of a good or service is transferred from one person to another, but may also occur through renting and borrowing.</td>
</tr>
<tr>
<td>Example: Is the swimsuit available at a price you can afford and are willing to pay?</td>
</tr>
</tbody>
</table>
In the technological world, the need for human capital has increased significantly. Juan’s expertise at growing fruit and vegetables and his father’s knowledge and skill needed to operate a store are examples of labor and human capital.

**CAPITAL GOODS** To produce goods that people want, producers need capital goods. Capital goods are buildings, tools, machines, and other equipment that are used to produce other goods but do not directly satisfy human wants. A robot on a car assembly line is an example of a capital good. The robot does not directly satisfy human wants. Instead, it helps make the cars that do satisfy human wants. Capital goods allow the production of goods in large quantities which, in turn, should decrease production costs and increase the productivity of labor.

**ENTREPRENEURSHIP** For the production of goods, more is needed than the mere availability of natural resources, labor, and capital goods. Someone, or some group, must take the risks involved in starting a business and plan and manage the production of the final product. Entrepreneurship, the fourth factor of production, brings together the other three factors—land (natural resources), labor, and capital. By starting and managing a business, Juan and his father are acting as entrepreneurs. You will learn more about the many aspects of management in Unit 4.

Because government provides many services that are essential to the operation of a business, economists often list it as a fifth factor of production. Some of the essential services provided by government are streets and highways, police and fire protection, and courts that settle disputes.

**CHECKPOINT**

What are the four basic resources used by a producer?

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**Capital Formation**

The production of capital goods is called *capital formation*. Capital goods, such as buildings and equipment, are needed to produce consumer goods and services. The Ford truck that Juan uses to deliver farm products to the store is a capital good. Unlike capital goods, *consumer goods and services* are goods and services that directly satisfy people’s economic wants. The foods that Juan’s father sells customers are consumer goods.

A country is capable of producing a fixed quantity of goods and services at any one time. As a result, total production is divided between capital goods and consumer goods and services. When the production of consumer goods and services increases, the production of capital goods decreases. On the other hand, when the production of consumer goods and services decreases, the production of capital goods increases. New capital goods must be made—capital formation—in order to add to the total supply and to replace worn-out capital goods. Capital formation takes place, for example, when steel is used to produce the tools and machinery (capital goods) needed to make cars rather than to produce the cars themselves (consumer goods).

When productive resources are used for capital formation, it becomes possible to produce more consumer goods. For example, when robots and other tools and
machinery are produced for making trucks, it is then possible to increase the pro-
duction of trucks.

However, using steel, labor, and management to produce tools and machinery
(capital goods) means that these same resources cannot also be used for automo-
biles (consumer goods). The immediate result is that consumers have fewer auto-
mobiles to buy. But, because the tools and machinery were made, consumers will
have more automobiles to buy in the future. China and other developing countries
are examples of nations that use a large portion of their productive resources in
capital formation rather than in the production of consumer goods and services.
Developing nations must take this first step before they can satisfy consumers with
consumer products.

CHECKPOINT
Create a list of capital goods and a list of consumer goods.

3.1 Assessment

UNDERSTAND MANAGEMENT CONCEPTS
Circle the best answer for each of the following questions.

1. The body of knowledge that relates to producing and using goods
   and services that satisfy human wants is called
   a. needs analysis
   b. marketing
   c. economics
   d. none of the above

2. The ability of a good or a service to satisfy a want is called
   a. economizing wants
   b. utility
   c. production
   d. benefiting

THINK CRITICALLY
Answer the following questions as completely as possible.

3. What are the four most common types of utility?
4. What is the difference between capital goods
   and consumer goods?
3.2 Economic Systems

**Goals**
- Discuss three economic systems and three economic-political systems.
- Explain why a business considers the economic-political system of a country.

**Terms**
- economic system
- market economy
- command economy
- mixed economy
- privatization
- capitalism
- socialism
- communism

Economists play an important role in regulating the economy. They help identify companies who engage in monopolistic practices (limiting supply) or illegal pricing strategies to drive out competition. As economic watchdogs, they help ensure ethical behavior.

Remember that no country has enough resources to satisfy all the wants of all people for material goods and services. Because productive resources are scarce, difficult decisions must be made about how to use these limited resources. For example, somehow countries must decide whether to produce more capital goods and fewer consumer goods or more consumer goods and fewer capital goods.

**Economic Systems**

All countries have an economic system. An **economic system** is an organized way for a country to decide how to use its productive resources; that is, to decide what, how, and for whom goods and services will be produced. While there are many countries in the world, all economies operate under some form of three basic economic systems, described below.

**TYPES OF ECONOMIC SYSTEMS**

The primary types of economic systems are a market economy, a command economy, and a mixed economy. All countries’ economic systems have characteristics of these basic three types.

A **market economy** is an economic system in which individual buying decisions in the marketplace together determine what, how, and for whom goods and services will be produced. For example, if more consumers choose to buy whole-grain bread than white bread, their buying decisions will influence bread producers to use their productive resources to produce more whole-grain and less white bread. Thus, individual consumers, making their own decisions about what to buy, collectively determine how the society’s productive resources will be used. In a market economy, individual citizens, rather than the government, own most of the factors of production, such as land and manufacturing facilities. The free-enterprise system found in the United States is the best example of a market economy.

A **command economy** is an economic system in which a central planning authority, under the control of the country’s government, owns most of the factors of production and determines what, how, and for whom goods and services will be produced. Countries that adopt a command economy are often dictatorships. The government, rather than consumers, decides how the factors of production will be used. Forms of command economies exist in some Asian countries—North Korea, Cambodia, and Vietnam—and in other small countries, such as Cuba.
A **mixed economy** is an economic system that uses aspects of a market and a command economy to make decisions about what, how, and for whom goods and services will be produced. In a mixed economy, the national government makes production decisions for certain goods and services. For example, the post office, telephone system, schools, health care facilities, and public utilities are often owned and operated by governments.

No country has a pure market economy or command economy. All have mixed economies, although some have more elements of a market economy and others have more elements of a command economy. In the United States and Canada, for example, the government plays a smaller role in the economy than it does in the more command-oriented economies of Cuba and North Korea. Even countries of the former Soviet Union, once a predominantly command economy, now allow some privately owned businesses to operate freely and make their own economic decisions, such as what to offer for sale and at what prices. China and Iran do as well.

Today most countries are moving more toward market economies. For example, England, France, Sweden, Mexico, and Eastern European countries have restricted the number of goods and services owned and controlled by national governments. China also has been making major attempts to move more toward a market economy.

**Privatization** is the transfer of authority to provide a good or service from a government to individuals or privately owned businesses. Some governments of former Soviet countries have sold telephone and transportation services to private firms. Some states and cities in these countries have privatized by paying businesses to operate jails, collect trash, run cafeterias in government buildings, and perform data-processing activities. The governments’ incentive is to reduce costs for taxpayers and to increase efficiency.

**CHECKPOINT**

Explain how a market economy differs from a command economy.
Types of Economic-Political Systems

Each country has an economic system and a political system. The political system nearly always determines the economic system. Because the two systems cannot be separated, we refer to them as an economic-political system.

The importance of the individual citizen has always been emphasized in the United States. Therefore, the United States developed an economic-political system that permits a great deal of individual freedom. History tells us that there is a relationship between political and economic freedom; that is, political freedom usually is found in countries where individuals and businesses have economic freedom. And political freedom is quite limited in countries that do not give people and organizations much economic freedom.

All economic-political systems are forms of three basic types: capitalism, socialism, and communism. As you read about these three economic-political systems, compare their features as shown in Figure 3-2.

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**FIGURE 3-2 Three main economic-political systems exist throughout the world.**

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
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</tr>
<tr>
<td>Market/ Mixed Economy</td>
</tr>
<tr>
<td>Who may own natural resources and capital goods?</td>
</tr>
<tr>
<td>How are resources allocated?</td>
</tr>
<tr>
<td>To what extent does government attempt to control business decisions?</td>
</tr>
<tr>
<td>How are marketing decisions made?</td>
</tr>
<tr>
<td>What one country is a good example of this economic system?</td>
</tr>
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</tr>
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**CAPITALISM**

The economic-political system in the United States is called capitalism, or the free-enterprise system, which operates in a democracy. Capitalism is an economic-political system in which private citizens are free to go into business for themselves, to produce whatever they choose to produce, and to distribute what they produce. Also included is the right to own property.

This strict definition of capitalism would have accurately described our economic system during much of the 19th century and the early part of the 20th century. In recent decades, however, government has assumed an important economic role in the United States. As the economy developed without controls by government, certain abuses took place. For example, some people began to interfere with the economic freedom of others. Some large businesses began to exploit small businesses. In addition, manufacturing firms did not take into account the cost of pollution. In essence, these costs were passed on to the public. For example, assume a firm produced a new type of pesticide and sold it to farmers and gardeners. Several years after some pesticide had washed into streams and lakes, it was found to kill fish and harm swimmers. Neither the producer nor the buyers of the pesticide were required to pay for damages. The public ultimately pays in the form of poor health and medical costs as well as in the inability to safely swim in lakes and other bodies of water. To protect the public and to correct such abuses, Congress passed laws, many of which require producers to avoid harm to the public or reduce the costs to the public of the producers’ operations.

**SOCIALISM**

Socialism is an economic-political system in which the government controls the use of the country’s factors of production. How scarce resources are used to satisfy the many wants of people is decided, in part, by the government.

Socialists do not agree as to how much of the productive resources government should own. The most extreme socialists want government to own all natural resources and capital goods. Middle-of-the-road socialists believe that planning production for the whole economy can be achieved if government owns certain key industries, but they also believe that other productive resources should be owned by individuals and businesses. As a result, socialism is often associated with mixed economies.

Socialism is generally disliked in the United States because it limits the right of the individual to own property for productive purposes. The right to own property, however, exists in socialistic economies in different degrees, depending upon the amount of government ownership and control. Socialism in its different forms exists in many countries, particularly in the Western European countries of Sweden and France.

**COMMUNISM**

Communism is extreme socialism, in which all or almost all of a nation’s factors of production are owned by the government. Decisions regarding what to produce, how much to produce, and how to divide the results of production among the citizens are made by government agencies on the basis of a government plan. Government measures how well producers perform on the basis of volume of goods and services produced, without much regard for the quality of or demand for the goods or services. A command economy is most often practiced by communist countries.

Consumer goods are often in short supply in communist countries such as Cuba and North Korea, because the government channels a large proportion of
the factors of production toward capital formation. Even Chinese leaders have recognized the shortcomings of the system when it comes to meeting the needs of consumers. As a result, they are making adjustments that introduce market economy principles. Two such adjustments are judging the performance of producers by the demand for their products and permitting consumer demand to influence production.

Workers in a communist system cannot move easily from one job to another. And managers of businesses do not decide what is to be produced. A communist country’s central planning agency makes most such decisions. Capitalism relies, instead, on consumers and managers to make these decisions. People in a pure communist society do not own property. All economic decisions are made by government leaders. These leaders decide how scarce resources will be used. The members of a communist country have few of the economic freedoms that Americans believe are important.

CHECKPOINT
List three types of economic-political systems.

3.2 Assessment

UNDERSTAND MANAGEMENT CONCEPTS
Circle the best answer for each of the following questions.

1. An organized way for a country to decide how to use its productive resources is called a(n)
   a. economic system
   b. political system
   c. economic-political system
   d. political economy

2. Jax lives in a country where only individual buying decisions in the marketplace determine what, how, and for whom goods and services will be produced. Jax lives in a country that has primarily a
   a. market economy
   b. command economy
   c. socialist economy
   d. none of the above

THINK CRITICALLY
Answer the following questions as completely as possible.

3. Describe why most countries can be seen as having a mixed economy.
4. Describe the goals of privatizing government services.
Fundamentals of Capitalism

Goals
• Describe why private property is important to capitalism.
• Describe how prices are set in a capitalistic system.

Terms
• private property
• profit
• demand
• supply
• competition

Some economic-political systems either do not permit ownership of property (communism) or may impose limitations on ownership (socialism). One of the basic features of capitalism is the right to private property, a right reserved to the people by the Constitution. Other features include the right of each business to make a profit, to set its own prices, to compete, and to determine the wages paid to workers.

Private Property

The principle of private property is essential to our capitalistic system. Private property consists of items of value that individuals have the right to own, use, and sell. Thus, individuals can control productive resources. They can own land, hire labor, and own capital goods. They can use these resources to produce goods and services. Also, individuals own the products made from their use of land, labor, and capital goods. Thus, the company that produces furniture owns the furniture it makes. The furniture company may sell its furniture, and it owns the money received from the buyer. The Gonzales family owns its store, the farm it purchased, and the food it produces and buys before selling it. And the family is entitled to make and keep its profits.

Profit

In a capitalist system, the incentive as well as the reward for producing goods and services is profit, which is computed by subtracting the total costs of producing the products from the total received from customers who buy them. The company making furniture, for example, has costs for land, labor, capital goods, and materials. Profit is what the furniture company has left after subtracting these costs from the amount received from selling its furniture.

The profit earned by a business is often overestimated by society. The average profit is about 5 percent of total receipts while the remainder, 95 percent, represents costs. Consider a motel with yearly receipts of $500,000. If the profit amounts to 5 percent, then the owner earns $25,000; that is, $500,000 times 0.05. Costs for the year are 0.95 times $500,000, or $475,000. Some types of businesses have higher average profit percentages, but many have lower ones or even losses. Owners, of course, try to earn a profit percentage that is better than average.
Being in business does not guarantee that a company will make a profit. Among other things, to be successful a company must produce goods or services that people want at a price they are willing to pay. Other fundamental features of capitalism covered next deal with competition and the distribution of income.

**CHECKPOINT**

Explain why private property is essential to a capitalistic system.

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**Price Setting**

**Demand** for a product refers to the number of products that will be bought at a given time at a given price. Thus, demand is not the same as want. Wanting an expensive luxury car without having the money to buy one does not represent demand. Demand for a Mercedes Benz is represented by the people who want it, have the money to buy it, and are willing to spend the money for it.

There is a relationship between price and demand. With increased demand, prices generally rise in the short run. Later, when demand decreases, prices generally fall. For example, if a new large-screen TV suddenly becomes popular, its price may rise. However, when the TV is no longer in high demand, its price will likely drop.

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**business note**

Microsoft Corporation recently announced an initiative to use a sell/lease strategy to put computers in the hands of poor people around the world. The system would work like pay-for-minutes cell phones. Individuals would buy a computer at a reduced price and then pay for usage over time. Microsoft has two goals with this strategy. One is to increase the overall sales of Microsoft software. The other goal is economic development. Putting computers into the hands of billions of people around the world can increase their education and productivity.
The supply of a product also influences its price. Supply of a product refers to the number of like products that will be offered for sale at a particular time and at a certain price. If there is a current shortage in the supply of a product, its price will usually rise as consumers bid against one another to obtain the product. For example, if bad weather damages an apple crop and apples are in short supply, the price of apples will go up. When apples become more abundant, their price will go down. Thus, price changes are the result of changes in both the demand for and the supply of a product.

Generally, changes in prices determine what is produced and how much is produced in our economy. Price changes indicate to businesses what is profitable or not profitable to produce. If consumers want more sports shoes than are being produced, they will bid up the price of sports shoes. The increase in the price of the shoes makes it more profitable to make them and provides the incentive for manufacturers to increase the production of sports shoes. As the supply of the shoes increases to satisfy the demand for more shoes, the price of the shoes will fall. Because it is now less profitable to make sports shoes, manufacturers will decrease their production of them.

Prices, then, are determined by the forces of supply and demand; that is, prices are the result of the decisions of individual consumers to buy products and of individual producers to make and sell products. Therefore, consumers help decide what will be produced and how much will be produced.

Here is how supply and demand work in setting prices. Refer to Figure 3-3 as you study this example of a producer planning to sell a sweatshirt. In Figure 3-3, the market price for the sweatshirt, $30, is shown where the supply line crosses the demand line. The market price is the price at which the producer can meet costs.

![Figure 3-3: Supply and demand for a producer's sweatshirt determine market price.](image)
and make a reasonable profit. It is also the price at which consumers will buy enough of the product for the producer to make a reasonable profit.

If demand drops, profit drops; but if demand increases, the producer’s profits will increase. If the profit gets quite large, other producers will enter into production with similar sweatshirts, which will then increase the total supply and lower the price. If the supply and demand lines never cross, the producer will not make the goods, because not enough consumers will want the product at the offered price and the profit reward disappears. If Juan Gonzales grows a new type of apple but only a small number of people buy them, he will lose money and stop growing those apples.

**COMPETITION**

In our free-enterprise system, sellers try to make a profit and buyers try to buy quality goods at the lowest possible prices. This conflict of interest between buyers and sellers is settled to the benefit of society by competition. **Competition** is the rivalry among sellers for consumers’ dollars.

Competition in a free-enterprise system benefits society in many ways. To attract customers away from other sellers, a business must improve the quality of its products, develop new products, and operate efficiently in order to keep its prices down. Thus, competition serves to ensure that consumers will get the quality products they want at fair prices. In addition to benefiting consumers, competition benefits the country because it tends to make all businesses use our scarce productive resources efficiently. If a firm does not operate efficiently, it will fail because customers will buy lower-priced or higher-quality products from a firm that is operating efficiently. Often these competing firms are from foreign countries. Competition in our economic system also provides the chance for people to go into business for themselves and to share in the profits being made by those already in business.

One aspect of competition is price competition. Price competition occurs when a firm takes business away from its competitors by lowering prices for identical products.
goods. Today, however, more and more competition takes place in the form of nonprice competition. For example, a company attracts customers away from other sellers by providing products of better quality or by adding features to the product that competitors do not have. Or a company may attract customers away from competitors with unusual and colorful product packaging. Another company may conduct an extensive advertising campaign to convince the public that its product is better than all other brands. All these are effective devices used in nonprice competition.

Competition is the opposite of monopoly. Monopoly is the existence of only one seller of a product. With no competition, a monopolist can charge unreasonably high prices and make extraordinary profits. For example, if a seller does not have to compete with other sellers for consumer dollars, it can usually increase profit by raising the price. Consumers have no choice. If they want that product, they must pay whatever price the monopolist sets. As you will learn in Chapter 7, legislation exists that encourages competition and discourages monopolistic practices.

**INCOME DISTRIBUTION**

Not only must all countries decide how scarce productive resources are to be used, but they must also decide how the goods produced will be divided among the people in the society. In a free-enterprise economy, the share of goods produced that an individual receives is determined by the amount of money that person has to purchase goods and services.

People receive income—wages and salaries—by contributing their labor to the production of goods and services. People also receive income as interest on money that they lend to others, as rent for land or buildings that they own, and as profit if they are owners of businesses.

The amount of money an individual receives in wages or salary is determined by many factors, including personal traits and abilities. The same factors that

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**How do supply and demand affect the wages or salaries in the types of business you are most interested in?**
determine the prices of goods are also important factors in determining wages and salaries; that is, the amount of wages paid for a particular kind of labor is affected by the supply of and demand for that kind of labor. The demand is low and the supply is high for unskilled workers. Thus, the price (income) of unskilled workers is low. On the other hand, the demand for brain surgeons is high in terms of the supply of brain surgeons and the services they provide; therefore, their price (income) is high.

CHECKPOINT

What special feature of a free-enterprise system helps keep the prices of goods and services down?

UNDERSTAND MANAGEMENT CONCEPTS

Circle the best answer for each of the following questions.

1. Items of value that individuals have the right to own, use, and sell are known as
   a. public goods
   b. product utility
   c. private property
   d. all of the above

2. The number of products that will be bought at a given time at a given price is called
   a. supply
   b. demand
   c. price
   d. quantity

THINK CRITICALLY

Answer the following questions as completely as possible.

3. Explain how the overestimation of profits earned by a business can affect a society.

4. Explain how supply and demand help determine the price of goods and services.
India’s population numbers around 1 billion, and about 40 percent are under 25 years of age. By the year 2015, about 55 percent will be in this same age group. Although the national average income per person is only $450, this youth group will shift the old India to a new India for themselves, their families, and their country. As a dominantly socialist country, India is moving toward capitalism as the young open new businesses and modify how business is conducted. How? The answer is the electronic age.

Computers and the Internet are already quickly modifying the culture of India. Unlike their parents, children are buying computers, cellular phones, and other electronic gear. They are mingling among the world’s citizens through television and the Internet. New technological devices make it easy for them to communicate with relatives and friends and to chat with people from other lands. It is not uncommon for India’s youth to buy cellular phones and charge fees to villagers without phones who wish to make calls, such as to distant family members. The money these entrepreneurs make often provides income for their families and allows them to stay closer to home rather than leave for one of the large, crowded cities. This helps to provide a better life for millions of village people. Most youth feel a strong pride in their country and are helping families improve their standard of living.

Computers are a primary tool enabling India’s youth to become a powerful force in producing rapid economic advances. The youth attend computer schools and have a strong desire to start and run their own Internet-type firms. They also admire young people from other countries who have started their own computer companies, such as Bill Gates of Microsoft Corporation. They are profit motivated while at the same time respecting their cultural traditions. Much to the surprise of their elders, young women are also using computers, starting businesses, and shedding or modifying past cultural practices that are honored by their parents. For these reasons, many adults are both concerned about and proud of their children. India’s youth are in the process of changing India’s view of itself to the rest of the world.

Focus On...

Global Perspectives—India’s Changing Economy

1. If India has 1 billion people now, how many people are now under 40 years of age? If by the year 2015 the population is 1.2 billion, how many people will be under 25 years of age?
2. From your knowledge of economic-political systems, what key factors probably exist in India that make it currently a socialist country?
3. How will India’s youth contribute to making the country more capitalistic than it currently is?
4. From the library or the Internet, find out more about the general nature of the country. Such information can be found in an up-to-date encyclopedia in print or online, such as at www.encarta.msn.com/.
### 3.4 Managing the Economy

**Goals**
- Explain how economic growth can be promoted and measured.
- List basic economic problems that exist and state what government can do to correct the problems.

**Terms**
- economic growth
- consumer price index (CPI)
- recession
- inflation
- business cycles
- depression

The strength of a nation depends upon its economic growth. Economic growth is measured by an annual increase in the gross domestic product, increased employment opportunities, and the continuous development of new and improved goods and services. However, growth cannot always be at the most desired rate. As you will soon learn, when the economy grows too fast or too slow, businesses and consumers suffer. Of concern to everyone is the promotion and measurement of such growth along with the identification and control of growth problems.

#### Promoting Economic Growth

**Economic growth** occurs when a country’s output exceeds its population growth. As a result, more goods and services are available for each person. Growth has occurred and must continue if a nation is to remain economically strong.

The following are basic ways to increase the production of goods and services in order to encourage economic growth:

1. Increase the number of people in the workforce.
2. Increase the productivity of the workforce by improving human capital through education and job training.
3. Increase the supply of capital goods, such as more tools and machines, in order to increase production and sales.
4. Improve technology by inventing new and better machines and better methods for producing goods and services.
5. Redesign work processes in factories and offices to improve efficiency.
6. Increase the sale of goods and services to foreign countries.
7. Decrease the purchase of goods and services from foreign countries.

For economic growth to occur, more is required than just increasing the production of goods and services. More goods and services must also be consumed. The incentive for producing goods and services in a free-enterprise economy is profit. If the goods and services produced are in demand and are profitable, business has the incentive to increase production.

Economic growth is basic to a healthy economy. Through such growth more and better products become available, such as a new drug that cures a disease, a battery that runs a small computer for months, and fuel-efficient cars. More and better services also become available, such as those provided by hospitals, travel agencies, and banks. But more important, economic growth is needed to provide jobs for those who wish to work.
MEASURING ECONOMIC GROWTH

To know whether the economy is growing at a desirable rate, statistics must be gathered. The federal government collects vast amounts of information and uses a variety of figures to keep track of the economy. The gross domestic product (GDP) that was discussed in Chapter 1 is an extremely valuable statistic. Another is the Consumer Price Index.

The Consumer Price Index (CPI) indicates what is happening in general to prices in the country. It is a measure of the average change in prices of consumer goods and services typically purchased by people living in urban areas. To calculate the CPI, the government tracks price changes for hundreds of items, including food, gasoline, housing, and even cellular phones. With the CPI, comparisons can be made in the cost of living from month to month or from year to year, as shown in Figure 3-4.

Some commonly used indicators for tracking the economy are shown in Figure 3-5. Government economists and business leaders examine the CPI, GDP, and other statistics each month to evaluate the condition of the economy. If the growth rate appears to be undesirable, the government can take corrective action.

CHECKPOINT

List the basic ways of encouraging economic growth.

FIGURE 3-4 The cost of living doubled between 1983 and 2006.
Identifying Economic Problems

Problems occur with the economy when the growth rate jumps ahead or drops back too quickly. One problem that occurs is a recession, which is a decline in the GDP that continues for six months or more. A recession occurs when demand for the total goods and services available is less than the supply. Sales drop, production of goods and services declines, and unemployment occurs during recessions. In most recessions, the rate of increase in prices is reduced greatly, and in some cases prices may actually decline slightly.

Another problem arises when consumers want to buy goods and services that are not readily available. As revealed in the Consumer Price Index, this increased demand causes prices for existing goods and services to rise. Inflation is the rapid rise in prices caused by an inadequate supply of goods and services. In other words, total demand exceeds supply. Inflation results in a decline in the purchasing power of money; that is, a dollar does not buy as much as it did before inflation. Retired people and those with fixed incomes are financially hurt the most, because their incomes don’t increase fast enough to keep up with rising prices. Therefore, their buying power decreases faster during inflation than does the buying power of workers who receive raises from their employers. The effect of inflation on the purchasing power of the dollar is shown in Figure 3-6 (see p. 72).
Most industrialized nations experience business cycles, a pattern of irregular but repeated expansion and contraction of the GDP. Business cycles, on average, last about five years and pass through four phases, as shown in Figure 3-7. These four phases—expansion, peak, contraction, and trough—can vary in length and in intensity, with many lasting only a few years. Some, however, can be severe. When statistics show that the economy may be about to enter a recessionary period (a contraction) or an inflationary period (an expansion), the government can take certain actions. Several specific devices used include controlling taxes, regulating government expenditures, and adjusting interest rates.

One way to control economic growth is to raise or lower taxes. Taxes are raised to slow growth and lowered to encourage growth. When taxes are raised, there is less money to spend, which discourages economic growth. When taxes are lowered, people and businesses have more money to spend, which encourages economic growth.

What are some of the indicators that an economy may be heading for a recession?
Government expenditures also influence economic growth. The federal government operates by spending billions of dollars each year to pay salaries and to buy equipment. Government can increase its spending to stimulate a slow economy or reduce spending to slow economic growth.

In addition, economic growth is regulated through interest rates, the money paid to borrow money. Borrowing by businesses and consumers generates spending. Spending stimulates economic growth. When interest rates are lowered, businesses are encouraged to borrow. This stimulates business activity and, in turn, the economy. When interest rates are raised to discourage borrowing, a slowdown occurs.

Through interest rates, government spending, taxes, and other devices, the rate of economic growth can be controlled somewhat. Control, however, is usually kept to a minimum in a free-enterprise system. Furthermore, in a complex economic system, the results of such controls are not always clearly visible in the short run. Economists do not always know exactly when control devices should be used, for how long they should be applied, or how effective they may be. Although the nature of controls can be debated, some control is needed to prevent a destructive runaway inflationary period or a depression—a long and severe drop in the

许多行业贸易组织试图维持其产品的市场需求。他们通过创造广告来影响消费者消费和游说政府来影响贸易政策来实现这一点。访问www.thomsonedu.com/school/bpmxtra. 通过创建广告来影响消费者消费和游说政府来影响贸易政策。访问www.thomsonedu.com/school/bpmxtra.
GDP. Such conditions affect not only U.S. citizens but also the economic climate of foreign countries.

Because most nations engage in international trade and because of the impact of global competition on nations, a major recession or depression in one country usually impacts negatively on other countries. For example, during the first half of the 1990s the United States experienced a period of recession and slow growth. Japan, Germany, France, England, and other major nations also faced similar circumstances shortly thereafter. Economic aspects of international trade will be discussed in the next chapter.

CHECKPOINT
Describe the two problems that occur when the economic growth rate jumps ahead or drops back too quickly.

3.4 Assessment

UNDERSTAND MANAGEMENT CONCEPTS

Circle the best answer for each of the following questions.

1. Which of the following are basic ways to increase the production of goods and services in order to encourage economic growth?
   a. Increase the number of people in the workforce.
   b. Decrease the purchase of goods and services from foreign countries.
   c. Improve technology by inventing new and better machines.
   d. All are ways to increase the production of goods and services.

2. A(n) ______ occurs when demand for the total goods and services available is less than the supply.
   a. inflation
   b. recession
   c. depression
   d. business cycle

THINK CRITICALLY

Answer the following questions as completely as possible.

3. Explain the three problems that can occur within an economy when the growth rate is too fast or too slow.

4. Explain how an economic system can control its business cycles.
CHAPTER CONCEPTS

• To produce goods and services, businesses use land (natural resources), labor, capital goods, and entrepreneurship. Because a nation does not have enough resources to satisfy everyone’s wants, it must decide what goods or services will be produced, how they will be produced, and who will get them.

• There are three basic economic systems. A market economy in a capitalistic society makes decisions through the forces of supply and demand. In a command economy, generally in a communist society, government makes these decisions. A mixed system has characteristics of both market and command economies.

• Capitalism is founded on basic principles: the right of individuals and businesses to own private property and produce goods and services; compete with other producers, set prices, and earn a profit; and buy whatever goods or services they like.

• In all political-economic systems, governments reserve the right to control unfair competition and to correct undesirable inflation and recession problems that occur in business cycles.

REVIEW TERMS AND CONCEPTS

Write the letter of the term that matches each definition. Some terms will not be used.

1. Economic-political system in which the government controls the use of the country’s factors of production
2. Human effort, either physical or mental, that goes into the production of goods and services
3. Anything provided by nature that affects the productive ability of a country
4. Rapid rise in prices caused by an inadequate supply of goods and services
5. Transfer of authority to provide a good or service from a government to individuals or privately owned businesses
6. Items of value that individuals have the right to own, use, and sell
7. Decline in the GDP that continues for six months or more
8. Ability of a good or a service to satisfy a want
9. Number of like products that will be offered for sale at a particular time and at a certain price
10. Desire for scarce material goods and services
11. Pattern of irregular but repeated expansion and contraction of the GDP
12. Buildings, tools, machines, and other equipment that are used to produce other goods but do not directly satisfy human wants

a. business cycles  
b. capital goods  
c. capitalism  
d. command economy  
e. communism  
f. demand  
g. depression  
h. economic wants  
i. human capital  
j. inflation  
k. labor  
l. mixed economy  
m. natural resources  
n. private property  
o. privatization  
p. recession  
q. socialism  
r. supply  
s. utility
DETERMINE THE BEST ANSWER

13. The free-enterprise system, which operates in a democracy, is called
   a. capitalism
   b. communism
   c. socialism
   d. free market

14. The average change in prices of consumer goods and services typically purchased by people living in urban areas is known as the
   a. Capital Price Index
   b. Consumer Price Index
   c. National Price Index
   d. Product Price Index

15. When a country’s output exceeds its population growth it will have
   a. inflation
   b. economic growth
   c. a recession
   d. none of the above

16. Factors of production include
   a. money only
   b. labor and capital goods only
   c. land (natural resources), labor, and capital goods only
   d. land (natural resources), labor, capital goods, and entrepreneurship

17. Which of the following is true about labor in today’s world?
   a. Low-cost labor is the key to U.S. competitiveness.
   b. Physical effort is much less important than mental effort.
   c. Computers will be able to take the place of mental effort.
   d. All of the above are true.

18. The accumulated knowledge and skills of human beings and the total value of each person’s education and acquired skills are called
   a. human capital
   b. human potential
   c. human knowledge
   d. human labor

19. An economic system that uses aspects of a market economy and a command economy to make decisions about what, how, and for whom goods and services will be produced is called a(n)
   a. average economy
   b. market economy
   c. mixed economy
   d. socialist economy

20. People have
   a. economic wants
   b. noneconomic wants
   c. both economic and noneconomic wants
   d. no wants
APPLY WHAT YOU KNOW

21. Describe how an economic want differs from a noneconomic want. Give an example of each.
22. Compare capitalism, socialism, and communism as to (a) how each allocates scarce resources among alternative wants and (b) the existence of private property.
23. Describe how form, place, and time utility apply to a small pizza business that just opened in your community.
24. Discuss why the following statement might be true: Economic decisions in a capitalist country are influenced by the federal government about 10 percent of the time; in a socialist country about 50 percent of the time; and in a communist country about 90 percent of the time.
25. Compare the three basic economic systems in terms of the economic opportunities available to businesses.

MAKE CONNECTIONS

26. Research Use your school library or the Internet to research the Great Depression. Identify the causes and the impact of the Great Depression on the economy of the United States. List the strategies that were used to move the U.S. economy out of the Great Depression.
27. Math Use the Consumer Price Index information provided in Figure 3-4 to determine the following.
   a. What was the percentage of increase between 1983 and 1998?
   b. What was the percentage of increase between 1998 and 2006?
   c. If the percentage of increase between 1983 and 2006 remains the same between 2006 and 2029, what will the CPI be in 2029?
28. Technology Use presentation software such as PowerPoint to show how a variety of technology tools are being used to increase labor productivity. Be specific with your examples.
29. Speaking Develop an argument in favor of or against one type of economic system outlined in the chapter. Relate your arguments to other points brought up in the chapter such as how economic wants are met, how utility is decided, how factors of production are distributed, and how capital is formed. Find someone in the class who has chosen a different economic system and debate the advantages and disadvantages of each system.
30. Writing Assume you are working for a politician who is running for office based on increasing economic growth in the United States. Write a speech indicating how the United States can obtain economic growth and what specifically the politician will do to create this growth.
CASE IN POINT

CASE 3-1: Using Information

Marsha and Carlos sat on a bench, looking at a newspaper. “Castro Experiments with Capitalism,” one headline read, while another shouted, “Headwinds in China’s Nudge to Market Economy.” “Brazil’s Inflation Out of Control,” read still another. Lower on the page could be seen “CPI Inches Downward.”

Marsha and Carlos read on. They were thinking about whether these stories had any bearing on their jobs and their lives. Finally, Carlos broke the silence.

Carlos:  Now I know why I never liked reading newspapers. The headlines don’t make any sense—nothing in common. The same stuff appears on the Internet. They jump all over the place, and most of the news is bad. And half of it isn’t understandable. Then we have to hear it again on TV and on the radio.

Marsha:  I try to read some of the articles, but it’s true many are unclear. For example, yesterday I saw “County Privatizes Trash Collection.” The headlines aren’t always clear, but fortunately things usually are explained in the stories. By reading each day, you learn more than you think you can, especially about economics.

Carlos:  The sports pages are what I read. You get the “stats” like team won/lost records and learn about how much the superstars are paid in contracts. Some of them make as much in one year as you and I will make in a lifetime. You don’t have to worry about inflation when you make $2 million.

Marsha:  Today’s headlines deal with economics and you’re talking economics when you deal with how much people are paid. If you like “stats,” you’ll like looking at the economic indicators. You have a contract with your employer, Carlos. Someday when you have more knowledge and skills to sell, your “contracts” will get larger, too.

Carlos:  Maybe I’ll take this paper and read some of those headline details later . . . after I find out who won last night’s big game between the Cowboys and the Bears. See you after work.

THINK CRITICALLY

1. Is the headline that reads “CPI Inches Downward” good news or bad news? Explain your answer.
2. What did all the headlines have in common?
3. Explain to Marsha what the county did when it “privatized” the trash service.
4. Bring the business section of a newspaper to class. Determine what economic ideas presented in this chapter are directly or indirectly revealed in one or more of the headlines. If your instructor decides to divide the class into groups, pick the two best stories in your group that cover the most important chapter ideas.
CASE 3-2: The Fruits of Economic Progress

Mei-ling and Yi Cheng and their four children live on a farm in China located near the large city of Shanghai. Life on the farm today is unlike it was when they were younger. Less than 10 years ago, the family was quite poor and lived in a run-down small home with no plumbing. There were seldom good times. Raising enough food to eat and to sell barely made ends meet, and the economy was not at all like today’s, with the GDP growing so rapidly.

Many people have moved to the city in order to earn more money and to learn new skills while working in new or growing businesses. Some of the factories are owned by foreign firms such as those based in Germany, Japan, and the United States. Yi travels to the city each day to work in one of the new plants, whereas Mei-ling runs the farm with her oldest son and other children when they are not in school. The family cannot afford to live in the city.

During the last few years, the Chengs have made improvements to their small home, adding indoor plumbing, a telephone, and a small television. Yi even has a cell phone that he uses with pride when bicycling the seven miles to and from work. The days are long, but life is getting easier. If things continue to improve, Yi may consider buying a motor scooter. The children want a computer but even a used one is an unaffordable luxury for now. The Chengs have learned that good times do not last forever. They must save for bad times, for the children’s education, and for retirement. There is no social security system to depend upon when Yi retires. And if someone becomes ill or injured, the government can provide only limited help. Yi is also concerned that his foreign employer might leave China because of government regulations that are often unfair to foreign competitors. For now, the happy times continue for the Chengs, who consider themselves somewhat well-off for a rural family.

THINK CRITICALLY

1. How does the current life of the Chengs compare with that of the average American family? By American standards, would they be classified at the poverty level? Explain your answer.
2. Do the Chengs live more under a capitalistic or a communistic system? Explain your answer.
3. Using the library or the Internet, find out whether the Chinese people who live in large cities have a better quality of life than do people like the Chengs who live in rural areas. Report your findings to the class.
4. What conditions exist or could occur that would cause Yi’s employer to leave China? Obtain information from your library or the Internet to make a report to the class.
STUDY THE COMPETITION

As a new business owner, you must be aware of the type of competition the business will face and the strengths and weaknesses of that competition. Also, you must determine customer demand for the business's products. Competition affects the prices you can charge for your products. You will study these factors in this segment of your project.

DATA COLLECTION

1. Identify five businesses in your area that could be considered competitors for your juice bar. Review the information from your work in Chapter 1 to help you. Rate each business on the basis of variety of products, location, prices, service, and image. Use a 1–5 scale, with 1 indicating the most competitive and 5 the least competitive.
2. Identify five products that would typically be offered on the menus of juice bars. Visit businesses in your area and determine the highest and lowest prices being charged for each of the products you identified.
3. Interview 10 people to determine how price affects their purchase decisions. Ask the following questions and summarize the responses
   a. How much would you usually expect to pay for a freshly prepared frozen juice drink?
   b. How important is the price when you decide to purchase that drink?
   c. What factors would cause you to pay a higher-than-normal price for a fresh juice drink?

ANALYSIS

1. A business must be able to satisfy consumer needs in order to be successful. Describe how your new business will provide the four basic utilities discussed in the textbook: form, place, time, and possession.
2. Identify four specific ways you can reduce the level of competition or increase the customer demand for your products.
3. Analyze the data you collected in the interviews for Data Collection #3 above. How important do you think the prices of your products will be to the success of your business? What is the evidence to support your decision? What nonprice factors do you believe will be important in attracting and keeping customers?
4. Identify five products you plan to offer at your juice bar. The products may be five varieties of juice drinks or other food products such as muffins and bagels. Make initial pricing decisions for each of your products. (You may decide to change the prices later.) If you will serve different sizes of drinks, make sure to price each size. Justify why you selected those prices.