



# BUSINESS

FERRELL | HIRT | FERRELL

6e



Entrepreneurship

Retail Disruption

Digital Marketing

Ethical Leadership

E-Business

Sharing Economy

Financial Literacy



**M** is Motivation.

**M** is Momentum.

**M** is Moving Forward.

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# business <sup>6e</sup>



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# business

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## M: BUSINESS, SIXTH EDITION

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# authors



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## O.C. FERRELL

O.C. Ferrell is the James T. Pursell, Sr., Eminent Scholar in Ethics and Director of the Center for Ethical Organizational Cultures in the Raymond J. Harbert College of Business, Auburn University. He was formerly Distinguished Professor of Leadership and Business Ethics at Belmont University. He has also been on the faculties of the University of Wyoming, Colorado State University, University of Memphis, Texas A&M University, Illinois State University, and Southern Illinois University. He received his PhD in marketing from Louisiana State University.

Dr. Ferrell is president-elect of the Academy of Marketing Science. He is past president of the Academic Council of the American Marketing Association and chaired the American Marketing Association Ethics Committee. Under his leadership, the committee developed the AMA Code of Ethics and the AMA Code of Ethics for Marketing on the Internet. In addition, he is a former member of the Academy of Marketing Science Board of Governors and is a Society of Marketing Advances and Southwestern Marketing Association Fellow and an Academy of Marketing Science Distinguished Fellow. He has served for nine years as the vice president of publications for the Academy of Marketing Science. In 2010, he received a Lifetime Achievement Award from the Macromarketing Society and a special award for service to doctoral students from the Southeast Doctoral Consortium. He received the Harold Berkman Lifetime Service Award from the Academy of Marketing Science and, more recently, the Cutco/Vector Distinguished Marketing Educator Award from the Academy of Marketing Science.

Dr. Ferrell has been involved in entrepreneurial engagements, co-founding Print Avenue in 1981, providing a solution-based printing company. He has been a consultant and served as an expert witness in legal cases related to marketing and business ethics litigation. He has conducted training for a number of global firms, including General Motors. His involvement with direct selling companies includes serving on the Academic Advisory Committee and as a fellow for the Direct Selling Education Foundation.

Dr. Ferrell is the co-author of 20 books and more than 100 published articles and papers. His articles have been published in the *Journal of Marketing Research*, *Journal of Marketing*, *Journal of Business Ethics*, *Journal of Business Research*, *Journal of the Academy of Marketing Science*, *AMS Review*, and the *Journal of Public Policy & Marketing*, as well as other journals.

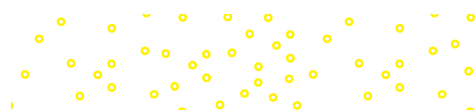


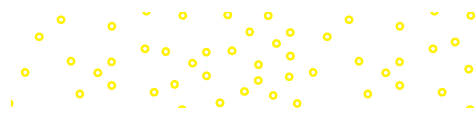
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## GEOFFREY A. HIRT

Geoffrey A. Hirt of DePaul University previously taught at Texas Christian University and Illinois State University, where he was chairman of the Department of Finance and Law. At DePaul, he was chairman of the Finance Department from 1987 to 1997 and held the title of Mesirov Financial Fellow. He developed the MBA program in Hong Kong and served as director of international initiatives for the College of Business, supervising overseas programs in Hong Kong, Prague, and Bahrain and was awarded the Spirit of St. Vincent DePaul award for his contributions to the university. Dr. Hirt directed the Chartered Financial Analysts (CFA) study program for the Investment Analysts Society of Chicago from 1987 to 2003. He has been a visiting professor at the University of Urbino in Italy, where he still maintains a relationship with the economics department. He received his PhD in finance from the University of Illinois at Champaign-Urbana, his MBA at Miami University of Ohio, and his BA from Ohio Wesleyan University.

Dr. Hirt is currently on the Dean's Advisory Board and Executive Committee of DePaul's School of Music. The Tyree Foundation funds innovative education programs in Chicago, and Dr. Hirt also serves on the Grant Committee. Dr. Hirt is past president and a current member of the Midwest Finance Association, a former editor of the *Journal of Financial Education*, and also a member of





the Financial Management Association. He belongs to the Pacific Pension Institute, an organization of public pension funds, private equity firms, and international organizations such as the Asian Development Bank, the IMF, and the European Bank for Reconstruction and Development.

Dr. Hirt is widely known for his textbook *Foundations of Financial Management*, published by McGraw-Hill/Irwin. This book, in its sixteenth edition, has been used in more than 31 countries and translated into more than 14 different languages. Additionally, Dr. Hirt is well known for his textbook *Fundamentals of Investment Management*, also published by McGraw-Hill/Irwin and now in its tenth edition. Dr. Hirt enjoys golf, swimming, music, and traveling with his wife, who is a pianist and opera coach.



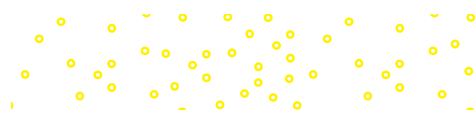
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## LINDA FERRELL

Linda Ferrell is Professor and Chair of the Marketing Department in the Raymond J. Harbert College of Business, Auburn University. She was formerly Distinguished Professor of Leadership and Business Ethics at Belmont University. She completed her PhD in business administration, with a concentration in management, at the University of Memphis. She has taught at the University of Tampa, Colorado State University, University of Northern Colorado, University of Memphis, University of Wyoming, and the University of New Mexico. She has also team-taught classes at Thammasat University in Bangkok, Thailand.

Her work experience as an account executive for McDonald's and Pizza Hut's advertising agencies supports her teaching of advertising, marketing management, marketing ethics, and marketing principles. She has published in the *Journal of Public Policy & Marketing*, *Journal of Business Research*, *Journal of the Academy of Marketing Science*, *Journal of Business Ethics*, *AMS Review*, *Journal of Academic Ethics*, *Journal of Marketing Education*, *Marketing Education Review*, *Journal of Teaching Business Ethics*, *Marketing Management Journal*, and *Case Research Journal*, and she is co-author of *Business Ethics: Ethical Decision Making and Cases* (eleventh edition), *Management* (third edition), and *Business and Society* (sixth edition).

Dr. Ferrell is the immediate past president of the Academy of Marketing Science and a past president for the Marketing Management Association. She is a member of the NASBA Center for the Public Trust Board, on the Mannatech Board of Directors, and on the college advisory board for Cutco/Vector. She is also on the Board, Executive Committee, and Academic Advisory Committee of the Direct Selling Education Foundation. She has served as an expert witness in cases related to advertising, business ethics, and consumer protection.



# Focused, Exciting, Applicable, Happening

***M: Business***, sixth edition, offers faculty and students a **focused** resource that is **exciting, applicable, and happening!** What sets this learning program apart from the competition? An unrivaled mixture of exciting content and resources blended with application-focused text and activities, and fresh topics and examples that show students what is happening in the world of business today!

Our product contains all of the essentials that most students should learn in a semester. *M: Business* has, since its inception, delivered a focused presentation of the essential material needed to teach introduction to business. An unrivaled mixture of exciting content and resources, application-focused content and activities, and fresh topics and examples that show students what is happening in the world of business today set this text apart!

## **FOCUSED!**

It's easy for students taking their first steps into business to become overwhelmed. Longer products try to solve this problem by chopping out examples or topics to make ad hoc shorter editions. *M: Business* carefully builds just the right mix of coverage and applications to give your students a firm grounding in business principles. Where other products have you sprinting through the semester to get everything in, Ferrell/Hirt/Ferrell allows you the breathing space to explore topics and incorporate other activities that are important to you and your students. The exceptional resources and the *Active Classroom Resource Manual* support you in this effort every step of the way.

## **EXCITING**

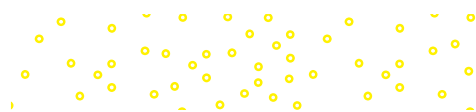
It's exciting to see students succeed! It's exciting to see more As and Bs in a course without grade inflation. Ferrell/Hirt/Ferrell makes these results possible for your course with its integrated learning package that is proven effective, tailored to each individual student, and easy to use.

## **APPLICABLE**

When students see how content applies to them, their life, their career, and the world around them, they are more engaged in the course. *M: Business* helps students maximize their learning efforts by setting clear objectives; delivering interesting cases and examples; focusing on core issues; and providing engaging activities to apply concepts, build skills, and solve problems.

## **HAPPENING!**

Because it isn't tied to the revision cycle of a larger book, *M: Business* inherits no outdated or irrelevant examples or coverage. Everything in the sixth edition reflects the very latest developments in the business world—from the recent recession, high unemployment rates, and the financial instability in Europe to the growth of digital marketing and social networking. In addition, ethics continues to be a key issue, and Ferrell/Hirt/Ferrell use “Consider Ethics and Social Responsibility” boxes to instill in students the importance of ethical conduct in business. To ensure you always know what's happening, join the authorized Facebook group page supporting this text.



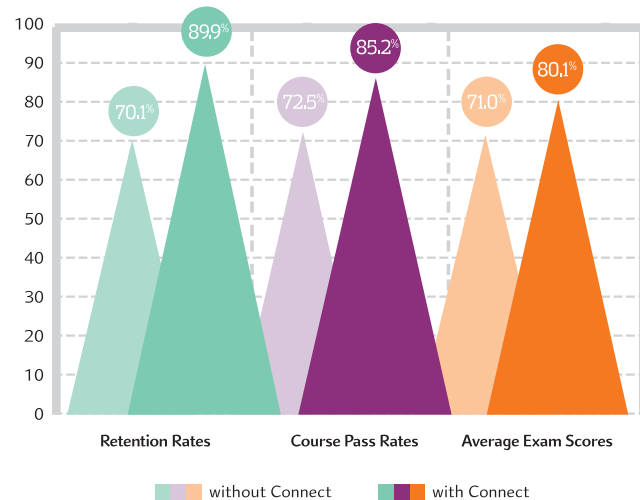
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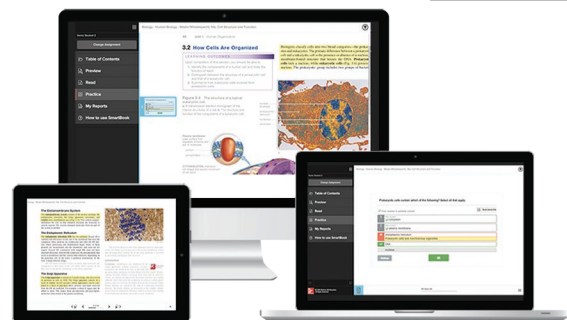


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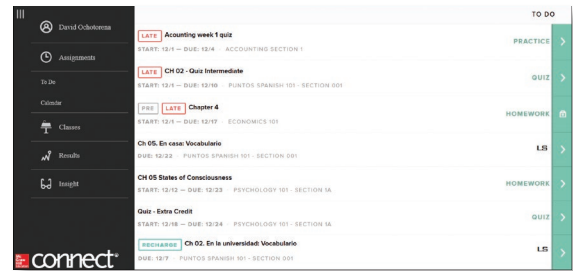


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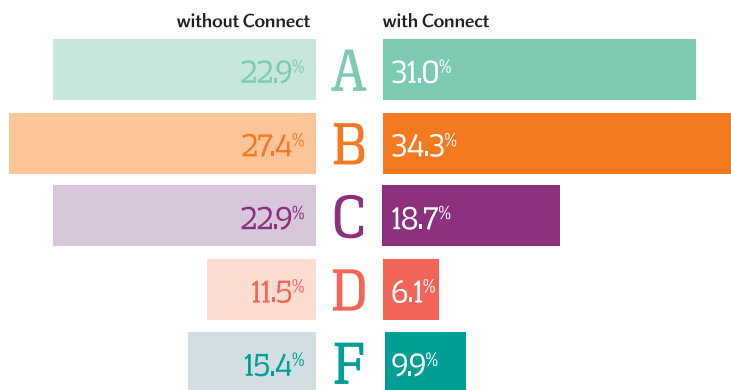
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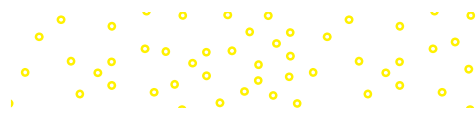


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# New to This Edition

As always, when revising material for the current edition, all examples, figures, and statistics have been updated to incorporate any recent developments that affect the world of business. Additionally, content was updated to ensure the most pertinent topical coverage is provided.

Here are the highlights for each chapter:

## Chapter one

### THE DYNAMICS OF BUSINESS AND ECONOMICS

- Three new boxed features describing real-world business issues
- A new section on “The Importance of the American Economy”
- New examples of real-world business issues
- New material on standard of living

## Chapter two

### BUSINESS ETHICS AND SOCIAL RESPONSIBILITY

- Three new boxed features describing issues in business ethics and social responsibility
- New examples of ethical issues facing today’s businesses

## Chapter two appendix

### THE LEGAL AND REGULATORY ENVIRONMENT

- A new section on Source of Law
- A new section on Courts and the Resolution of Disputes
- A new section on Regulatory Administrative Agencies
- A new section on the Important Elements of Business Law
- A new section on Laws Affecting Business Practices
- A new section on The Internet and Legal and Regulatory Issues
- A new section on Legal Pressure for Responsible Business Conduct

## Chapter three

### BUSINESS IN A BORDERLESS WORLD

- Three new boxed features describing issues in international business
- New examples of international business practices
- Updated data for the top 10 countries with which the United States has trade deficits and surpluses

## Chapter four

### OPTIONS FOR ORGANIZING BUSINESS

- Three new boxed features describing real-world business issues
- New examples of organizing business
- Updated list of major worldwide mergers and acquisitions from 2007 to 2017

## Chapter five

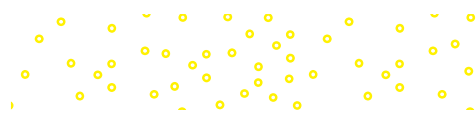
### SMALL BUSINESS, ENTREPRENEURSHIP, AND FRANCHISING

- Three new boxed features describing current business issues
- New section on the sharing economy
- New examples of small business, entrepreneurship, and franchising
- Updated data on number of firms by employment size
- Updated data on most business-friendly states

## Chapter six

### THE NATURE OF MANAGEMENT

- Three new boxed features describing current business issues
- New examples of management in business practices
- Updated data on CEO compensation packages
- Inside look at the leadership of Starbucks





## Chapter seven

### ORGANIZATION, TEAMWORK, AND COMMUNICATION

- Three new boxed features describing current business issues
- New figure describing desired attitudes and behaviors associated with corporate culture
- New examples of organization, teamwork, and communication in business

## Chapter eight

### MANAGING SERVICE AND MANUFACTURING OPERATIONS

- Three new boxed features describing current business operational issues
- New examples of managing service and manufacturing operations
- Updated airline scorecard data

## Chapter nine

### MOTIVATING THE WORKFORCE

- Three new boxed features describing current business issues
- New examples of motivating employees in the workforce
- Updated information on best places for businesses and careers

## Chapter ten

### MANAGING HUMAN RESOURCES

- Three new boxed features describing current HR issues
- New examples of managing human resources in business practices

## Chapter eleven

### CUSTOMER-DRIVEN MARKETING

- Three new boxed features describing current marketing issues
- New material on marketing analytics
- New examples of customer-driven marketing
- Updated data for buying power of U.S. minorities by race
- Updated statistics of companies with the best consumer service

## Chapter twelve

### DIMENSIONS OF MARKETING STRATEGY

- Three new boxed features describing current marketing issues
- New examples of marketing strategy in business
- Updated data on the 10 most valuable brands in the world

## Chapter thirteen

### DIGITAL MARKETING AND SOCIAL NETWORKING

- Three new boxed features describing current digital marketing issues
- New examples of digital marketing and social networking
- New learning objective to understand online monitoring and analytics for social media
- New section on Social Media Marketing
- New section on Consumer-Generated Digital Media
- Snapchat, YouTube, and LinkedIn added to the Social Network section
- New section on Online Monitoring and Analytics

## Chapter fourteen

### ACCOUNTING AND FINANCIAL STATEMENTS

- Three new boxed features describing current accounting issues
- New learning objective to analyze financial statements, using ratio analysis, to evaluate a company's performance
- New information on the financial information and ratios of Microsoft
- Financial ratio comparisons of Microsoft and Google
- New examples of accounting and financial statements in business practices

## Chapter fifteen

### MONEY AND THE FINANCIAL SYSTEM

- Three new boxed features describing current financial issues
- New material on reward cards
- New examples of financial systems in business

## Chapter sixteen

### FINANCIAL MANAGEMENT AND SECURITIES MARKETS

- Three new boxed features describing current financial issues
- New examples of financial management and securities in business
- Updated examples of U.S. corporate bond quotes
- Updated data for estimated common stock price-earnings ratios and dividends for selected companies

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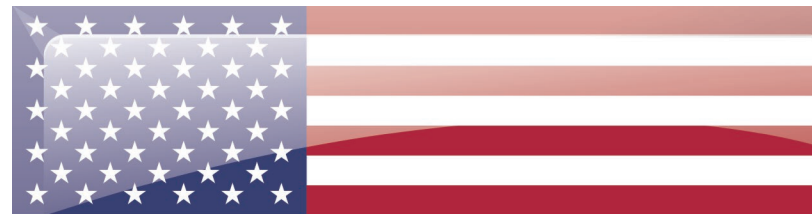
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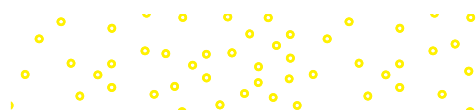
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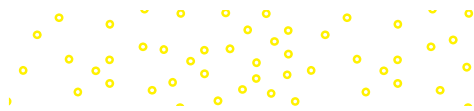
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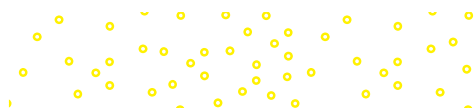
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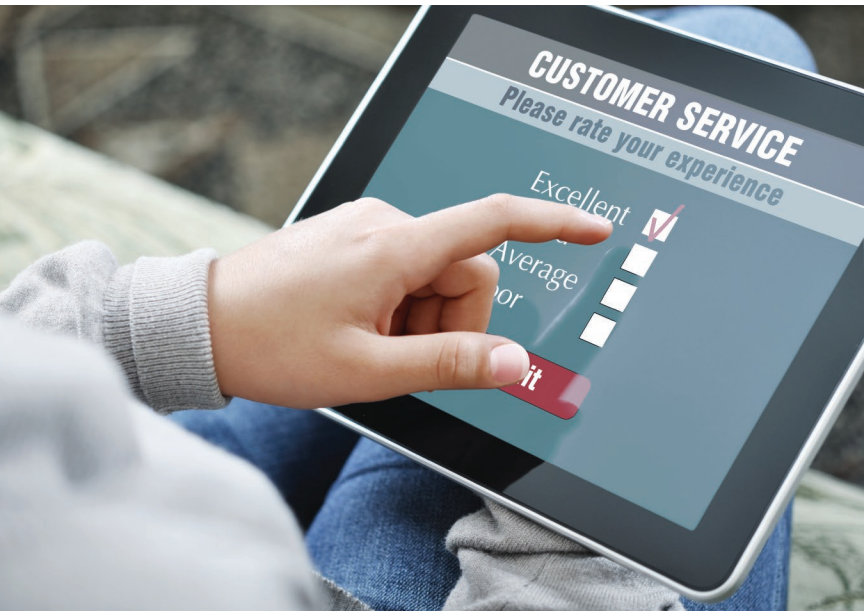
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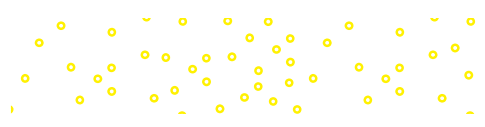
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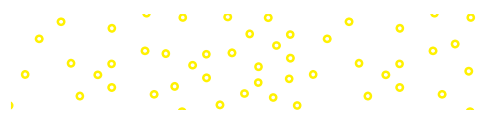
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# business <sup>6e</sup>



# the dynamics of business and economics

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## LEARNING OBJECTIVES

*After reading this chapter, you will be able to:*

- |   |  |
|---|--|
| <b>LO 1-1</b> Define basic concepts such as business, product, and profit.  | <b>LO 1-4</b> Describe the role of supply, demand, and competition in a free-enterprise system.                    |
| <b>LO 1-2</b> Identify the main participants and activities of business and explain why studying business is important. | <b>LO 1-5</b> Specify why and how the health of the economy is measured.   |
| <b>LO 1-3</b> Define economics and compare the four types of economic systems.  | <b>LO 1-6</b> Trace the evolution of the American economy and discuss the role of the entrepreneur in the economy. |

We begin our study of business in this chapter by examining the fundamentals of business and economics. First, we introduce the nature of business, including its goals, activities, and participants. Next, we describe

the basics of economics and apply them to the U.S. economy. Finally, we establish a framework for studying business in this text. ■

**LO 1-1** Define basic concepts such as business, product, and profit.

## THE NATURE OF BUSINESS

A **business** tries to earn a profit by providing products that satisfy people's needs. The outcomes of its efforts are **products** that have both tangible and intangible characteristics that provide satisfaction and benefits. When you purchase a product, you are buying the benefits and satisfaction you think the product will provide. A Subway sandwich, for example, may be purchased to satisfy hunger, while a Honda Accord may be purchased to satisfy the need for transportation and the desire to present a certain image.

Most people associate the word *product* with tangible goods—an automobile, smartphone, jeans, or some other tangible item. However, a product can also be a service, which occurs when people or machines provide or process something of value to customers. Dry cleaning, a checkup by a doctor, a movie or sports event—these are examples of services. Some services, such as Instagram, do not charge a fee for use but obtain revenue from ads on their sites. A product can also be an idea. Accountants and attorneys, for example, generate ideas for solving problems.

### The Goal of Business

The primary goal of all businesses is to earn a **profit**, the difference between what it costs to make and sell a product and what a customer pays for it. In addition, a business has to pay for all expenses necessary to operate. If a company spends \$8 to produce, finance, promote, and distribute a product that it sells for \$10, the business earns a profit of \$2 on each product sold. Businesses have the right to keep and use their profits as they choose—within legal limits—because profit is the reward for their efforts and for the risks they take in providing products. Earning profits contributes to society by creating resources that support our social institutions and government. Businesses that create profits, pay taxes, and create jobs are the foundation of our economy. In addition, profits must be earned in a responsible manner. Not all organizations are businesses, however. **Nonprofit organizations**—such as National Public Radio (NPR), Habitat for Humanity, and other charities and social causes—do not have the fundamental purpose of earning profits, although they may provide goods or services and engage in fund-raising. They also utilize skills related to management, marketing, and finance. Profits earned

by businesses support nonprofit organizations through donations from employees.

To earn a profit, a person or organization needs management skills to plan, organize, and control the activities of the business and to find and develop employees so that it can make products consumers will buy. A business also needs marketing expertise to learn what products consumers need and want and to develop, manufacture, price, promote, and distribute those products. Additionally, a business needs financial resources and skills to fund, maintain, and expand its operations. A business must cover the cost of labor, operate facilities, pay taxes, and provide management. Other challenges for businesspeople include abiding by laws and government regulations, and adapting to economic, technological, political, and social changes. Even nonprofit organizations engage in management, marketing, and finance activities to help reach their goals.

To achieve and maintain profitability, businesses have found that they must produce quality products, operate efficiently, and be socially responsible and ethical in dealing with customers, employees, investors, government regulators, and the community. Because these groups have a stake in the success and outcomes of a business, they are sometimes called **stakeholders**. Many businesses, for example, are concerned about how the production and distribution of their products affect the environment. New fuel requirements are forcing automakers to invest in smaller, lightweight cars. Electric vehicles may be a solution, but only about 1 percent of new car sales are plug-in-electric.<sup>1</sup> Other businesses are concerned with promoting science, engineering, and mathematics careers among women. Traditionally, these careers have been male dominated. A global survey found that when the number of men and

**business** individuals or organizations who try to earn a profit by providing products that satisfy people's needs.

**product** a good or service with tangible and intangible characteristics that provide satisfaction and benefits.

**profit** the difference between what it costs to make and sell a product and what a customer pays for it.

**nonprofit organizations** organizations that may provide goods or services but do not have the fundamental purpose of earning profits.

**stakeholders** groups that have a stake in the success and outcomes of a business.



Sustainability is a growing concern among both consumers and businesses. Walmart has invested in solar panels at some of its stores to decrease its energy usage.

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women were evenly matched, the team was 23 percent more likely to have an increase in profit over teams dominated by one gender.<sup>2</sup> Nonprofit organizations, such as the American Red Cross, use business activities to support natural-disaster victims, relief efforts, and a national blood supply.

**LO 1-2** Identify the main participants and activities of business and explain why studying business is important.

## The People and Activities of Business

Figure 1.1 shows the people and activities involved in business. At the center of the figure are owners, employees, and customers; the outer circle includes the primary business activities—management, marketing, and finance. Owners have to put up resources—money or credit—to start a business. Employees are responsible for the work that goes on within a business. Owners can manage the business themselves or hire employees to accomplish this task. The president and CEO of Procter & Gamble, David S. Taylor, does not own P&G but is an employee who is responsible for managing all the other employees in a way that earns a profit for investors, who are the real owners. Finally, and most importantly, a business’s major role is to satisfy the customers who buy its goods or services. Note also that forces beyond an organization’s control—such as legal and regulatory forces, the economy, competition, technology, the political environment, and ethical and social concerns—all have an impact on the daily operations of businesses. You will learn more about these

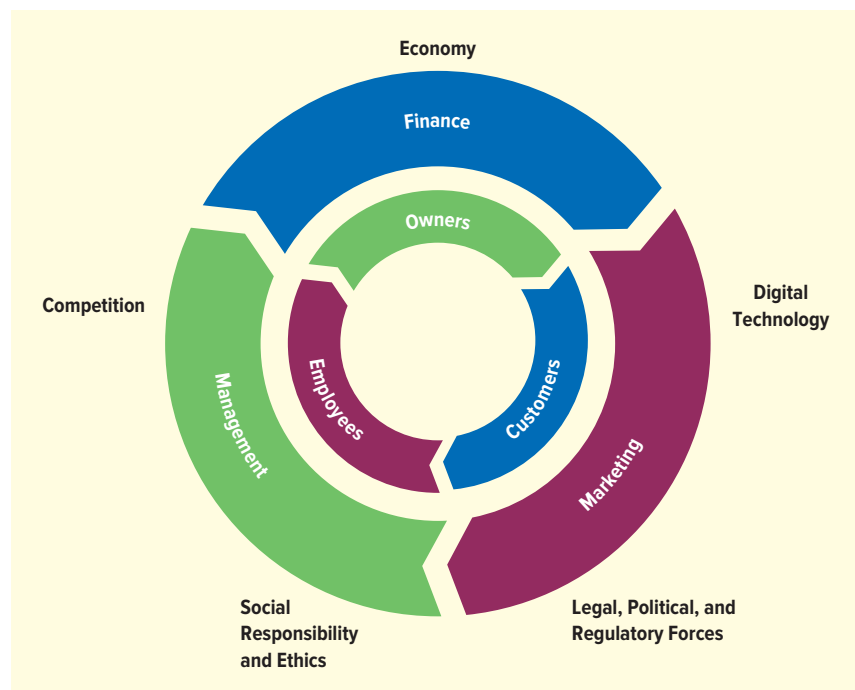
participants in business activities throughout this book. Next, we will examine the major activities of business.

**Management.** Notice that in Figure 1.1, management and employees are in the same segment of the circle. This is because management involves developing plans, coordinating employees’ actions to achieve the firm’s goals, organizing people to work efficiently, and motivating them to achieve the business’s goals. Management involves the functions of planning, organizing, leading, and controlling. Effective managers who are skilled in these functions display effective leadership, decision making, and delegation of work tasks. Management is also concerned with acquiring, developing, and using resources (including people) effectively and efficiently.

Operations is another element of management. Managers must oversee the firm’s operations to ensure that resources are successfully transformed into goods and services. Although most people associate operations with the development of goods, operations management applies just as strongly to services. Managers at the Ritz-Carlton, for instance, are concerned with transforming resources such as employee actions and hotel amenities into a quality customer service experience. In essence, managers plan, organize, staff, and control the tasks required to carry out the work of the company or nonprofit organization. We take a closer look at management activities in Parts 3 and 4 of this text.

**Marketing.** Marketing and customers are in the same segment of Figure 1.1 because the focus of all marketing activities

**FIGURE 1.1**  
Overview of the Business World





The Aflac duck ad uses humor in its advertising to promote the insurance company.

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is satisfying customers. Marketing includes all the activities designed to provide goods and services that satisfy consumers' needs and wants. Marketers gather information and conduct research to determine what customers want. Using information gathered from marketing research, marketers plan and develop products and make decisions about how much to charge for their products and when and where to make them available. They also analyze the marketing environment to understand changes in competition and consumers. The retail environment is changing based on competition from online retailing such as Amazon. This has caused some retail stores and malls to close.<sup>3</sup> Marketing focuses on the four P's—product, price, place (or distribution), and promotion—also known as the marketing mix. Product management involves such key management decisions as product adoption, development, branding, and product positioning. Selecting the right price for the product is essential to the organization as it relates directly to profitability. Distribution is an important management concern because it involves making sure products are available to consumers in the right place at the right time. Marketers use promotion—advertising, personal selling, sales promotion (coupons, games, sweepstakes, movie tie-ins), and publicity—to communicate the benefits and advantages of their products to consumers and to increase sales. We will examine marketing activities in Part 5 of this text.

**Finance.** Owners and finance are in the same part of Figure 1.1 because, although management and marketing have to deal with financial considerations, it is the primary responsibility of the owners to provide financial resources for the operation of the business. Moreover, the owners have the most to lose if the business fails to make a profit. Finance refers to all activities concerned with obtaining money and using it effectively.

People who work as accountants, stockbrokers, investment advisors, or bankers are all part of the financial world. Owners sometimes have to borrow money from banks to get started or attract additional investors who become partners or stockholders. Owners of small businesses in particular often rely on bank loans for funding. Part 6 of this text discusses financial management.

## Why Study Business?

Studying business can help you develop skills and acquire knowledge to prepare for your future career, regardless of whether you plan to work for a multinational *Fortune* 500 firm, start your own business, work for a government agency, or manage or volunteer at a nonprofit organization. The field of business offers a variety of interesting and challenging career opportunities throughout the world, such as mar-

keting, human resources management, information technology, finance, production and operations, wholesaling and retailing, and many more.

Studying business can also help you better understand the many business activities that are necessary to provide satisfying goods and services. Some businesses such as Snap, parent company of Snapchat, are operating for many years at a loss to build market share. Most businesses charge a reasonable price for their products to ensure that they cover their production costs, pay their employees, provide their owners with a return on their investment, and perhaps give something back to their local communities and societies. Habitat for



Many companies engage in socially responsible behavior to give back to their communities. Home Depot partners with Habitat for Humanity to build homes for disadvantaged families.

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**economics** the study of how resources are distributed for the production of goods and services within a social system.

**natural resources** land, forests, minerals, water, and other things that are not made by people.


**human resources (labor)** the physical and mental abilities that people use to produce goods and services.

**financial resources (capital)** the funds used to acquire the natural and human resources needed to provide products.

**economic system** a description of how a particular society distributes its resources to produce goods and services.

Humanity is an international nonprofit organization building housing for those who cannot afford simple, decent housing. Habitat operates like a business relying on volunteer labor and offers no-interest mortgages for repayment. Habitat ReStore is a retail unit that sells new and used building materials that are donated. The Home Depot Foundation provided grants to remodel and renovate homes of U.S. military veterans.<sup>4</sup> Thus, learning about business can help you become a well-informed consumer and member of society.

Business activities help generate the profits that are essential not only to individual businesses and local economies, but also to the health of the global economy. Without profits, businesses find it difficult, if not impossible, to buy more raw materials, hire more employees, attract more capital, and create additional products that, in turn, make more profits and fuel the world economy. Understanding how our free-enterprise economic system allocates resources and provides incentives for industry and the workplace is important to everyone.

 **LO 1-3** Define economics and compare the four types of economic systems.

## THE ECONOMIC FOUNDATIONS OF BUSINESS

To continue our introduction to business, it is useful to explore the economic environment in which business is conducted. In this section, we examine economic systems, the free-enterprise system, the concepts of supply and demand, and the role of competition. These concepts play important roles in determining how businesses operate in a particular society.

**Economics** is the study of how resources are distributed for the production of goods and services within a social system. You are already familiar with the types of resources available. Land, forests, minerals, water, and other things that are not made by people are **natural resources**. **Human resources**, or **labor**, refer to the physical and mental abilities that people use to produce goods and services. **Financial resources**, or **capital**, are the funds used to acquire the natural and human resources needed to provide products. These resources are related to the *factors of production*, consisting of land, labor, capital, and enterprise used to produce goods and services. The firm can also have intangible resources such as a good reputation for quality products or being socially responsible. The goal

is to turn the factors of production and intangible resources into a competitive advantage.

### Economic Systems

An **economic system** describes how a particular society distributes its resources to produce goods and services. A central issue of economics is how to fulfill an unlimited demand for goods and services in a world with a limited supply of resources. Different economic systems attempt to resolve this central issue in numerous ways, as we shall see.

Although economic systems handle the distribution of resources in different ways, all economic systems must address three important issues:

1. What goods and services, and how much of each, will satisfy consumers' needs?
2. How will goods and services be produced, who will produce them, and with what resources will they be produced?
3. How are the goods and services to be distributed to consumers?

Communism, socialism, and capitalism, the basic economic systems found in the world today (Table 1.1), have fundamental differences in the way they address these issues. The factors of production in command economies are controlled by government planning. In many cases, the government owns or controls the production of goods and services. Communism and socialism are, therefore, considered command economies.

**Communism.** Karl Marx (1818–1883) first described **communism** as a society in which the people, without regard to class, own all the nation's resources. In his ideal political-economic system, everyone contributes according to ability and receives benefits according to need. In a communist economy, the people (through the government) own and operate all businesses and factors of production. Central government planning determines what goods and services satisfy citizens' needs, how the goods and services are produced, and how they are distributed. However, no true communist economy exists today that satisfies Marx's ideal.

On paper, communism appears to be efficient and equitable, producing less of a gap between rich and poor. In practice, however, communist economies have been marked by low standards of living, critical shortages of consumer goods, high prices, corruption, and little freedom. Russia, Poland, Hungary, and other eastern European nations have turned away from communism and toward economic systems governed by supply and demand rather than by central planning. However, their experiments with alternative economic systems have been

fraught with difficulty and hardship. Countries such as Venezuela have tried to incorporate communist economic principles without success. Even Cuba is experiencing changes to its predominately communist system. Massive government layoffs required many Cubans to turn toward the private sector, opening up more opportunities for entrepreneurship. The U.S. government has reestablished diplomatic relations with Cuba. Americans have more opportunities to visit Cuba than they have had for the past 50 years. Similarly, China has become the first communist country to make strong economic gains by adopting capitalist approaches to business. Economic prosperity has advanced in China with the government claiming to ensure market openness, equality, and fairness through state capitalism.<sup>5</sup> As a result of economic challenges, communism is declining and its future as an economic system is uncertain.



*The Federal Trade Commission enforces antitrust laws and monitors businesses to ensure fair competition.*

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**Socialism.** **Socialism** is an economic system in which the government owns and operates basic industries—postal service, telephone, utilities, transportation, health care, banking, and some manufacturing—but individuals own most businesses. For example, in France the postal service industry La Poste is fully owned by the French government and makes a profit. Central planning determines what basic goods and services are produced, how they are produced, and how they are distributed. Individuals and small businesses provide other goods and services based on consumer demand and the availability of resources. Citizens are dependent on the government for many goods and services.

Most socialist nations, such as Sweden, India, and Israel, are democratic and recognize basic individual freedoms. Citizens can vote for political offices, but central government planners usually

make decisions about what is best for the nation. People are free to go into the occupation of their choice, but they often work in government-operated organizations. Socialists believe their system permits a higher standard of living than other economic systems, but the difference often applies to the nation as a whole rather than to its individual citizens. Socialist economies profess egalitarianism—equal distribution of income and social services. They believe their economies are

**communism** first described by Karl Marx as a society in which the people, without regard to class, own all the nation's resources.

**socialism** an economic system in which the government owns and operates basic industries but individuals own most businesses.

▼ **TABLE 1.1** Comparison of Communism, Socialism, and Capitalism

	Communism	Socialism	Capitalism
Business ownership	Most businesses are owned and operated by the government.	The government owns and operates some basic industries; individuals own small businesses.	Individuals own and operate all businesses.
Competition	Government controls competition and the economy.	Restricted in basic industries; encouraged in small business.	Encouraged by market forces and government regulations.
Profits	Excess income goes to the government. The government supports social and economic institutions.	Profits earned by small businesses may be reinvested in the business; profits from government-owned industries go to the government.	Individuals and businesses are free to keep profits after paying taxes.
Product availability and price	Consumers have a limited choice of goods and services; prices are usually high.	Consumers have some choice of goods and services; prices are determined by supply and demand.	Consumers have a wide choice of goods and services; prices are determined by supply and demand.
Employment options	Little choice in choosing a career; most people work for government-owned industries or farms.	More choice of careers; many people work in government jobs.	Unlimited choice of careers.

### capitalism (free enterprise)

an economic system in which individuals own and operate the majority of businesses that provide goods and services.

### free-market system

pure capitalism, in which all economic decisions are made without government intervention.

### mixed economies

economies made up of elements from more than one economic system.

more stable than those of other nations. Although this may be true, taxes and unemployment are generally higher in socialist countries. However, countries like Denmark have a high standard of living and they rate high in being happy.

### Capitalism. Capitalism, or free enterprise,

is an economic system in which individuals own and operate the majority of businesses that provide goods and services. Competition, supply, and demand determine which goods and services are produced, how they are pro-

duced, and how they are distributed. The United States, Canada, Japan, and Australia are examples of economic systems based on capitalism.

owned and operated by private individuals. In capitalist United States, an independent federal agency operates the postal service and another independent agency operates the Tennessee Valley Authority, an electric utility. In Great Britain and Mexico, the governments are attempting to sell many state-run businesses to private individuals and companies. In Germany, the Deutsche Post is privatized and trades on the stock market. In once-communist Russia, Hungary, Poland, and other eastern European nations, capitalist ideas have been implemented, including private ownership of businesses.

Countries such as China and Russia have used state capitalism to advance the economy. State capitalism tries to integrate the powers of the state with the advantages of capitalism. It is led by the government but uses capitalistic tools such as listing state-owned companies on the stock market and embracing globalization.<sup>6</sup> State capitalism includes some of the world's largest companies such as Russia's Gazprom, which is the largest natural gas company. China's ability to make huge investments to

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There are two forms of capitalism: pure capitalism and modified capitalism. In pure capitalism, also called a **free-market system**, all economic decisions are made without government intervention. This economic system was first described by Adam Smith in *The Wealth of Nations* (1776). Smith, often called the father of capitalism, believed that the “invisible hand of competition” best regulates the economy. He argued that competition should determine what goods and services people need. Smith's system is also called *laissez-faire* (“let it be”) *capitalism* because the government does not interfere in business.

Modified capitalism differs from pure capitalism in that the government intervenes and regulates business to some extent. One of the ways in which the United States and Canadian governments regulate business is through laws. Laws such as the Federal Trade Commission Act, which created the Federal Trade Commission to enforce antitrust laws, illustrate the importance of the government's role in the economy. In the most recent recession, the government provided loans and took ownership positions in banks such as Citigroup, AIG (an insurance company), and General Motors. These actions were thought necessary to keep these firms from going out of business and creating a financial disaster for the economy.

**Mixed Economies.** No country practices a pure form of communism, socialism, or capitalism, although most tend to favor one system over the others. Most nations operate as **mixed economies**, which have elements from more than one economic system. In socialist Sweden, most businesses are

the point of creating entirely new industries puts many private industries at a disadvantage.<sup>7</sup>

## The Free-Enterprise System

Many economies—including those of the United States, Canada, and Japan—are based on free enterprise, and many communist and socialist countries, such as China and Russia, are applying more principles of free enterprise to their own economic systems. Free enterprise provides an opportunity for a business to succeed or fail on the basis of market demand. In a free-enterprise system, companies that can efficiently manufacture and sell products that consumers desire will probably succeed. Inefficient businesses and those that sell products that do not offer needed benefits will likely fail as consumers take their business to firms that have more competitive products.

A number of basic individual and business rights must exist for free enterprise to work. These rights are the goals of many countries that have recently embraced free enterprise.

1. Individuals must have the right to own property and to pass this property on to their heirs. This right motivates people to work hard and save to buy property.
2. Individuals and businesses must have the right to earn profits and to use the profits as they wish, within the constraints of their society's laws, principles, and values.
3. Individuals and businesses must have the right to make decisions that determine the way the business operates. Although there is government regulation, the philosophy in

countries like the United States and Australia is to permit maximum freedom within a set of rules of fairness.

- Individuals must have the right to choose what career to pursue, where to live, what goods and services to purchase, and more. Businesses must have the right to choose where to locate, what goods and services to produce, what resources to use in the production process, and so on.

Without these rights, businesses cannot function effectively because they are not motivated to succeed. Thus, these rights make possible the open exchange of goods and services. In the countries that favor free enterprise, such as the United States, citizens have the freedom to make many decisions about the employment they choose and create their own productivity systems. Many entrepreneurs are more productive in free-enterprise societies because personal and financial incentives are available that can aid in entrepreneurial success. For many entrepreneurs,

**demand** the number of goods and services that consumers are willing to buy at different prices at a specific time.

**supply** the number of products—goods and services—that businesses are willing to sell at different prices at a specific time.

**equilibrium price** the price at which the number of products that businesses are willing to supply equals the amount of products that consumers are willing to buy at a specific point in time.

**Supply** is the number of products that businesses are willing to sell at different prices at a specific time. In general, because the potential for profits is higher, businesses are willing to supply more of a good or service at higher prices. For example, a company that sells rugs may be willing to sell six at \$650 each, four at \$500 each, but just two at \$350 each. The relationship between the price of rugs and the quantity the company is willing to supply can be shown graphically with a *supply curve* (see Figure 1.2).

In Figure 1.2, the supply and demand curves intersect at the point where supply and demand are equal. The price at which

“Consumers are usually willing to buy more of an item as its price falls because they want to save money.”

their work becomes a part of their system of goals, values, and lifestyle. Consider the panelists (“sharks”) on the ABC program *Shark Tank* who give entrepreneurs a chance to receive funding to realize their dreams by deciding whether to invest in their projects. They include Barbara Corcoran, who built one of New York’s largest real estate companies; Mark Cuban, founder of Broadcast.com and MicroSolutions; and Daymond John, founder of clothing company FUBU, as well as others.<sup>8</sup>

**LO 1-4** Describe the role of supply, demand, and competition in a free-enterprise system.

## The Forces of Supply and Demand

In the United States and in other free-enterprise systems, the distribution of resources and products is determined by supply and demand. **Demand** is the number of goods and services that consumers are willing to buy at different prices at a specific time. From your own experience, you probably recognize that consumers are usually willing to buy more of an item as its price falls because they want to save money. Consider handmade rugs, for example. Consumers may be willing to buy six rugs at \$350 each, four at \$500 each, but only two at \$650 each. The relationship between the price and the number of rugs consumers are willing to buy can be shown graphically with a *demand curve* (see Figure 1.2).

the number of products that businesses are willing to supply equals the amount of products that consumers are willing to buy at a specific point in time is the **equilibrium price**. In our rug example, the company is willing to supply four rugs at \$500 each, and consumers are willing to buy four rugs at

**FIGURE 1.2** Equilibrium Price of Handmade Rugs

