



# FOUNDATIONS OF BUSINESS

PRIDE | HUGHES | KAPOOR

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# Foundations of Business

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*To Nancy, Allen, Carmen, Mike, Ashley, Charlie, J.R., and Gracie Pride*

*To the memory of my wife Peggy and to my mother Barbara Hughes*

*To my wife Theresa; my children Karen, Kathryn, and Dave;  
and in memory of my parents Ram and Sheela Kapoor*

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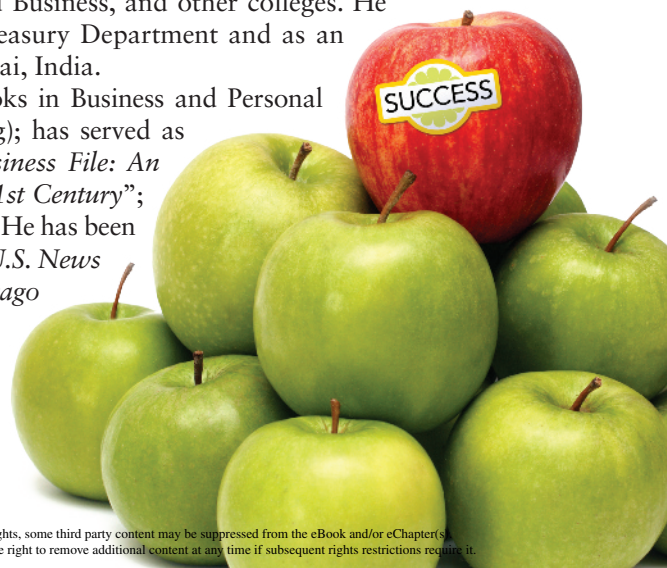
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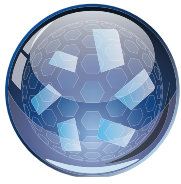
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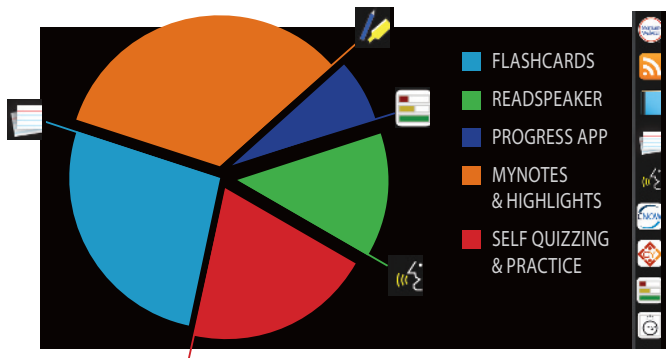
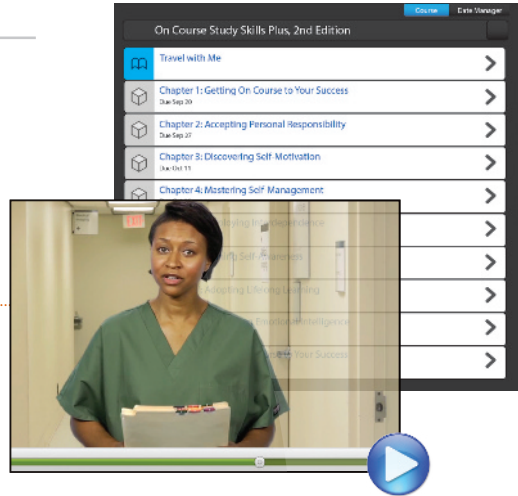
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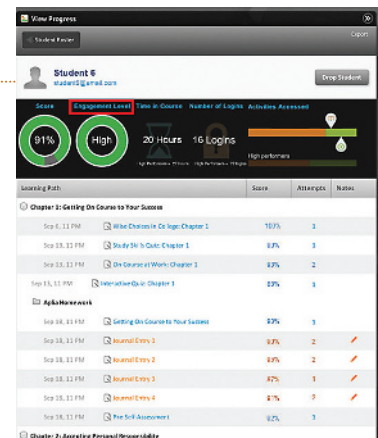
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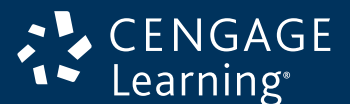
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## Part 1



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## CHAPTER

# 1

# Exploring the World of Business and Economics

## Why Should You Care?

Studying business will help you to choose a career, become a successful employee or manager, start your own business, and become a more informed consumer and better investor.

## Learning Objectives

What you will be able to do once you complete this chapter:

- 1-1 Discuss what you must do to be successful in the world of business.
- 1-2 Define *business* and identify potential risks and rewards.
- 1-3 Define *economics* and describe the two types of economic systems: capitalism and command economy.
- 1-4 Identify the ways to measure economic performance.
- 1-5 Examine the different phases in the typical business cycle.
- 1-6 Outline the four types of competition.
- 1-7 Summarize the factors that affect the business environment and the challenges that American businesses will encounter in the future.

## Visa's Vast Global Payments Empire

Handling the burgeoning volume of payments made via credit cards, debit cards, and mobile devices is the backbone of Visa's vast payments empire. Although cash remains popular in many parts of the world, the California-based company processes 96 billion transactions every year for consumers and businesses in 200 countries.

Visa's roots go back to 1958, when it was founded as BankAmericard, the credit card division of Bank of America. During the 1970s, the division became independent and was renamed Visa and became an umbrella for a series of payment-processing networks owned by banks in different regions. In 2007, these far-flung networks were united under the Visa name to form a single business that today is a publicly-traded corporation serving more than 14,000 banks and 2.3 billion cardholders worldwide. Its competition includes MasterCard—the second-largest payment network on the planet—and non-credit payment alternatives such as PayPal and Bitcoin.

During peak purchasing periods—such as the yearend holiday shopping season—Visa can process as many as 56,000 transactions per *second*. Most of these in-store and online payments are

made by customers using plastic. However, in today's fast-moving economy, a growing number of payments are digital-only, made by customers using smart phones or tablet computers. Visa has been innovating to serve these customers by offering services such as Visa Checkout, a digital wallet that powers payments made by mobile devices, and is part of the network that enables Apple Pay transactions via iPhones.

Looking ahead, Visa sees a lot of opportunity to expand within countries where cash has traditionally been king. By partnering with mobile-network firms throughout Asia, the company is setting the stage for a huge increase in digital payments made by customers on the go. Visa is also distributing tiny devices that turn a small business owner's smart phone into a mobile checkout terminal. So whether the small business is in Hanoi or Hartford, Visa makes it easy to authorize and complete the purchase within seconds.<sup>1</sup>

### Did You Know?

**Visa earns \$12 billion in revenue every year and has its brand name on 2.3 billion credit and debit cards issued worldwide.**

Wow! What a challenging world we live in. Just for a moment, think about how you would answer the question below.

*In the future, which of the following is the most serious problem facing Americans?*

- Government spending and the national debt.
- The high unemployment rate.
- A volatile stock market.
- Social unrest.
- An unstable economy and global business environment.

Unfortunately there is no one best answer because all of the above options are serious problems facing you, American businesses, and the nation. Ask almost anyone, and they will tell you that they are worried about at least one or more of the above problems. At the time of the publication of your text, there are signs of economic improvement. The unemployment rate has dropped, consumers are spending more money, gasoline and the price of crude oil have decreased, and the stock market has reached all-time highs. The fact is that people are more optimistic about their future and the future of our nation. And yet, remember that back in 2008 the nation was beginning one of the worst recession periods since the Great Depression in 1929. Simply put, the economic picture is brighter, but individuals, business leaders, and politicians, still worry about their future and the future of the nation.

Regardless of the current state of the economy, keep in mind that our economy continues to adapt and change to meet the challenges of an ever-changing world and to provide opportunities for those who want to achieve success. Our economic system also provides an amazing amount of freedom that allows businesses like Visa—the company profiled in the Inside Business opening case for this chapter—to adapt to changing business environments. To meet increased demand for its payment services—credit cards, debit cards, and mobile payment systems—Visa and its employees were able to introduce new products and services, earn a profit, and sell stock to the general public.

Within certain limits, imposed mainly to ensure public safety, the owners of a business can produce any legal good or service they choose and attempt to sell it at the price they set. This system of business, in which individuals decide what to produce, how to produce it, and at what price to sell it, is called **free enterprise**. Our free-enterprise system ensures, for example, that Amazon.com can sell everything from televisions, toys, and tools to computers, cameras, and clothing. Our system gives Amazon's owners and stockholders the right to make a profit from the company's success. It gives Amazon's management the right to compete with bookstore rival Barnes & Noble and electronics giant Sony. It also gives you—the consumer—the right to choose.

In this chapter, we look briefly at what business is and how it became that way. First, we discuss what you must do to be successful in the world of business and explore some important reasons for studying business. Next, we define *business*, noting how business organizations satisfy their customers' needs and earn profits. Then we examine how capitalism and command economies answer four basic economic questions. Next, our focus shifts to how the nations of the world measure economic performance, the phases in a typical business cycle, and the four types of competitive situations. Then we look at the events that helped shape today's business system, the current business environment, and the challenges that businesses face.

## 1-1 YOUR FUTURE IN THE CHANGING WORLD OF BUSINESS

### Learning Objective

1-1 Discuss what you must do to be successful in the world of business.

The key word in this heading is *changing*. When faced with both economic problems and increasing competition not only from firms in the United States but also from international firms located in other parts of the world, employees and managers began to ask the question: What do we do now? Although this is a fair question, it is difficult to answer. Certainly, for a college student taking business courses or an employee just starting a career, the question is even more difficult to answer. Yet there are still opportunities out there for people who are willing to work hard, continue to learn, and possess the ability to adapt to change. Let's begin this course with three basic concepts.

- What do you want?
- Why do you want it?
- Write it down!

During a segment on a national television talk show, Joe Dudley, one of the world's most respected black business owners, gave the preceding advice to anyone who wanted to succeed in business. His advice can help you achieve success. What is so amazing about Dudley's success is that he started a manufacturing business in his own kitchen, with his wife and children serving as the new firm's only employees. He went on to develop his own line of hair-care and cosmetic products sold directly to cosmetologists, barbers, beauty schools, and consumers in the United States and 18 foreign countries. Today, Mr. Dudley has a multimillion-dollar empire—one of the most successful minority-owned companies in the nation. He is not only a successful business owner but also a winner of the Horatio Alger Award—an award given to outstanding individuals who have succeeded in the face of adversity.<sup>2</sup>

**free enterprise** the system of business in which individuals are free to decide what to produce, how to produce it, and at what price to sell it

Although many people would say that Joe Dudley was just lucky or happened to be in the right place at the right time, the truth is that he became a success because he had a dream and worked hard to turn his dream into a reality. He would be the first to tell you that you have the same opportunities that he had. According to Mr. Dudley, “Success is a journey, not just a destination.”<sup>3</sup>

Whether you want to obtain part-time employment to pay college and living expenses, begin your career as a full-time employee, or start a business, you must *bring* something to the table that makes you different from the next person. Employers and our economic system are more demanding than ever before. Ask yourself: What can I do that will make employers want to pay me a salary? What skills do I have that employers need? With these two questions in mind, we begin the next section with another basic question: Why study business?

## 1-1a Why Study Business?

The potential benefits of higher education are enormous. To begin with, there are economic benefits. Over their lifetimes, college graduates on average earn much more than high school graduates. Although lifetime earnings are substantially higher for college graduates, so are annual income amounts (see Figure 1-1). In addition to higher income, you will find at least five compelling reasons for studying business.

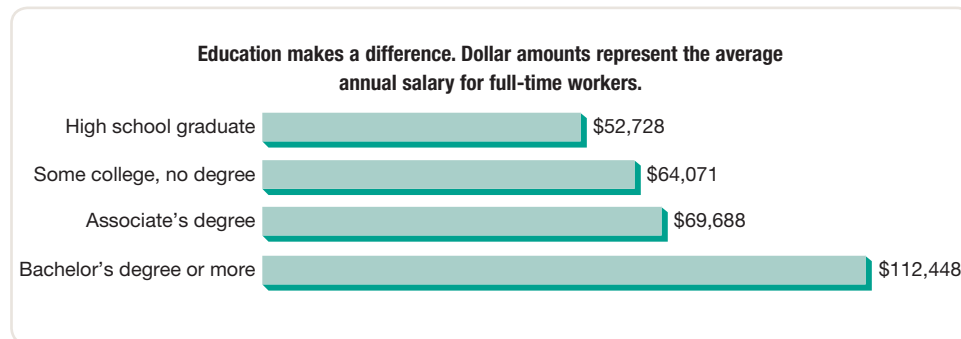
**FOR HELP IN CHOOSING A CAREER** What do you want to do with the rest of your life? Like many people, you may find it a difficult question to answer. This business course will introduce you to a wide array of employment opportunities. In private enterprise, these range from small, local businesses owned by one individual to large companies such as American Express and Marriott International that are owned by thousands of stockholders. There are also employment opportunities with federal, state, county, and local governments and with charitable organizations such as the Red Cross and Save the Children. For help in deciding which career might be right for you, read Appendix B: Careers in Business, which appears on the text website.

In addition to career information in Appendix B, a number of additional websites provide information about career development. For more information, visit the following sites:

- Career Builder at [www.careerbuilder.com](http://www.careerbuilder.com)
- Career One Stop at [www.careeronestop.org](http://www.careeronestop.org)
- Monster at [www.monster.com](http://www.monster.com)

To click your career into high gear, you can also use online networking to advance your career. Websites like Facebook, Twitter, LinkedIn, and other social media sites can help you locate job openings and help prospective employers to

**FIGURE 1-1** Who Makes The Most Money?



Source: “Educational Attainment of Householder—Households with Householder 25 Years Old and Over by Median and Mean Income,” The U.S. Census Bureau at [www.census.gov](http://www.census.gov) (accessed January 12, 2015).

find you. To make the most of online networking, begin by identifying and joining sites where you can connect with potential employers, former classmates, and others who may have or may hear of job openings. Next, be sure your online profiles, photographs, and posts communicate your abilities and interests. Finally, be ready to respond quickly when you spot a job opening.

One thing to remember as you think about what your ideal career might be is that a person's choice of a career ultimately is just a reflection of what he or she values and holds most important. What will give one individual personal satisfaction may not satisfy another. For example, one person may dream of a career as a corporate executive and becoming a millionaire before the age of 30. Another may choose a career that has more modest monetary rewards but that provides the opportunity to help others. What you choose to do with your life will be based on what you feel is most important. And *you* are a very important part of that decision.

**TO BE A SUCCESSFUL EMPLOYEE** Deciding on the type of career you want is only the first step. To get a job in your chosen field and to be successful at it, you will have to develop a plan, or a road map, that ensures that you have the skills and knowledge the job requires. You will also be expected to have the ability to work well with many types of people in a culturally diverse workforce. **Cultural (or workplace) diversity** refers to the differences among people in a workforce owing to race, ethnicity, and gender.

This course, your instructor, and all of the resources available at your college or university can help you to acquire the skills and knowledge you will need for a successful career. But do not underestimate your part in making your dream a reality. In addition to the job-related skills and knowledge you'll need to be successful in a specific career, employers will also look for the following characteristics when hiring a new employee or promoting an existing employee:

- Honesty and integrity
- Willingness to work hard
- Dependability
- Time management skills

**Cultural (or workplace) diversity** differences among people in a workforce owing to race, ethnicity, and gender

**What do you want to do with the rest of your life?** While some people know exactly what they want to do in life, many people have trouble choosing a career. Often it helps to begin a career search by asking "What do I value?" or "What's really important to me?" Ultimately, what you choose to do with your life is based on what you feel is most important. And you may be the most important part of the decision.



- Self-confidence
- Motivation
- Willingness to learn
- Communication skills
- Professionalism

Employers will also be interested in any work experience you may have had in cooperative work/school programs, during summer vacations, or in part-time jobs during the school year. In addition to job skills and knowledge, experience—even part-time work experience—can make a difference when it is time to apply for the job you really want.

**TO IMPROVE YOUR MANAGEMENT SKILLS** Many employees want to become managers because managers often receive higher salaries and can earn promotions within an organization. Although management obviously can be a rewarding career, what is not so obvious is the amount of time and hard work needed to achieve the higher salaries and promotions. For starters, employers expect more from managers and supervisors than ever before. Typically, the heavy workload requires that managers work long hours, and most do not get paid overtime. They also face increased problems created by an unstable economy, increased global competition, the quest for improved quality, and the need for efficient use of the firm's resources.

To be an effective manager, managers must be able to perform four basic management functions: planning, organizing, leading and motivating, and controlling. All four topics are discussed in Chapter 6, Understanding the Management Process. To successfully perform these management functions, managers must also possess four very important skills.

- *Interpersonal skills*—The ability to deal effectively with individual employees, other managers within the firm, and people outside the firm.
- *Analytic skills*—The ability to identify problems correctly, generate reasonable alternatives, and select the “best” alternatives to solve problems.
- *Technical skills*—The skill required to accomplish a specific kind of work being done in an organization. Although managers may not actually perform the technical tasks, they should be able to train employees and answer technical questions.
- *Conceptual skills*—The ability to think in abstract terms in order to see the “big picture.” Conceptual skills help managers understand how the various parts of an organization or an idea can fit together.

In addition to the four skills just described, a successful manager will need many of the same characteristics that an employee needs to be successful.

**TO START YOUR OWN BUSINESS** Some people prefer to work for themselves, and they open their own businesses. To be successful, business owners must possess

## Personal App



**Be the employee you'd like to hire!**



Think about what you'd look for if you were making hiring decisions, and strive to become that kind of employee. What characteristics, skills, and knowledge would make you an outstanding employee? Whether you expect to work for a big corporation, small business, government agency, or nonprofit group, understanding the basics of business will add to your attractiveness as an employee.

many of the same characteristics that successful employees and managers have, and they must be willing to work hard and put in long hours.

It also helps if your small business can provide a product or service that customers want. For example, Nick D'Aloisio, who lives in England, created his first app when he was 12. A few apps later he hit upon a new idea that propelled him into the major leagues of the app business world. This new app was based on a simple need: A way to summarize the information contained on a web page without having to read the entire page. To solve this problem and meet the needs of potential customers, D'Aloisio developed an algorithm that summarizes the key points in a few words. The app was called Summly and was sold on Apple's App website. Eventually, Yahoo! became interested in Summly *and* Nick D'Aloisio. The search engine purchased the app and asked D'Aloisio to develop a related product called Yahoo! News Digest which debuted in 2014. Was he just lucky? No, the secret of his success was that he met the needs of customers who were willing to buy the app.<sup>4</sup>

Unfortunately, many business firms fail: Approximately 70 percent of small businesses fail within the first ten years. Typical reasons for business failures include undercapitalization (not enough money), poor business location, poor customer service, unqualified or untrained employees, fraud, lack of a proper business plan, and failure to seek outside professional help. The material in Chapter 5, Small Business, Entrepreneurship, and Franchises, and selected topics and examples throughout this text will help you to decide whether you want to open your own business. The material in this course will also help you to overcome many of these problems.

**TO BECOME A BETTER INFORMED CONSUMER AND INVESTOR** The world of business surrounds us. You cannot buy a home, a new Ford Fusion Hybrid from the local Ford dealer, a pair of jeans at Gap Inc., or a hot dog from a street vendor without entering into a business transaction. Because you no doubt will engage in business transactions almost every day of your life, one very good reason for studying business is to become a more fully informed consumer.

Many people also rely on a basic understanding of business to help them to invest for the future. According to Julie Stav, Hispanic stockbroker-turned-author/radio personality, "Take \$25, add to it drive plus determination and then watch it multiply into an empire."<sup>5</sup> The author of *Get Your Share* and other personal finance help books believes that it is important to learn the basics about the economy and business, stocks, mutual funds, and other alternatives before investing your money. She also believes that it is never too early to start investing. Although this is an obvious conclusion, just dreaming of being rich does not make it happen. In fact, like many facets of life, it takes planning and determination to establish the type of investment program that will help you to accomplish your financial goals.

## 1-1b Special Note to Business Students

It is important to begin reading this text with one thing in mind: *This business course does not have to be difficult.* We have done everything possible to eliminate the problems that you encounter in a typical class. All of the features in each chapter have been evaluated and recommended by instructors with years of teaching experience. In addition, business students—just like you—were asked to critique each chapter component. Based on this feedback, the text includes the following features:

- *Learning objectives* appear at the beginning of each chapter.
- *Inside Business* is a chapter-opening case that highlights how successful, real-world companies do business on a day-to-day basis.
- *Margin notes* are used throughout a chapter to reinforce both learning objectives and key terms.
- *Boxed features* in each chapter highlight how both employees and entrepreneurs can be ethical and successful. Topics discussed in the boxed features include career success, entrepreneurial success, ethics, and social media.



- *A Personal App* in each chapter provides special student-centered examples and explanations that help you immediately grasp and retain the material.
- *Concept Checks* at the end of each major section within a chapter help you test your understanding of the major issues just discussed.
- *End-of-chapter materials* provide a chapter summary, a list of key terms, discussion questions, and a video case about a successful, real-world company.
- The last section of every chapter is entitled *Building Skills for Career Success* and includes exercises devoted to enhancing your social media skills, building team skills, and researching different careers.
- *End-of-part materials* provide a continuing video case about Graeter’s Ice Cream, a company that operates a chain of retail outlets in the Cincinnati, Ohio, area and sells to Kroger Stores and other retailers throughout the country. Also, at the end of each major part is an exercise designed to help you to develop the components that are included in a typical business plan.

In addition to the text, a number of student supplements will help you to explore the world of business. We are especially proud of the website that accompanies this edition. There, you will find online study aids, such as interactive Test Yourself quizzes, key terms and definitions, student PowerPoint slides, crossword puzzles, and links to the videos for each chapter. If you want to take a look at the Internet support materials available for this edition of *Foundations of Business*,

1. Go to [www.cengagebrain.com](http://www.cengagebrain.com).
2. At the CengageBrain.com home page, enter the ISBN for your book (located on the back cover of your book) in the search box at the top of the page. This will take you to the textbook website where companion resources can be found.

As authors, we want you to be successful. We know that your time is valuable and that your schedule is crowded with many different activities. We also appreciate the fact that textbooks are expensive. Therefore, we want you to use this text and get the most out of your investment. To help you get off to a good start, a number of suggestions for developing effective study skills and using this text are provided in Table 1-1.

**TABLE 1-1** Seven Ways to Use This Text and Its Resources

<b>1. Prepare before you go to class</b>	Early preparation is the key to success in many of life’s activities. Certainly, early preparation for this course can help you to participate in class, ask questions, and improve your performance on examinations.
<b>2. Read the chapter</b>	Although it may seem like an obvious suggestion, many students never take the time to really read the material. Find a quiet space where there are no distractions, and invest enough time to become a “content expert.”
<b>3. Underline or highlight important concepts</b>	Make this text yours. Do not be afraid to write on the pages of your text or highlight important material. When it is time to review for exams, it is much easier to review material if you have identified important concepts.
<b>4. Take notes</b>	While reading, take the time to jot down important points and summarize concepts in your own words. Also, take notes in class.
<b>5. Apply the concepts</b>	Learning is always easier if you can apply the content to your real-life situation. Think about how you could use the material either now or in the future.
<b>6. Practice critical thinking</b>	Test the material in the text. Do the concepts make sense? To build critical-thinking skills, answer the discussion questions and the questions that accompany the cases at the end of each chapter. Also, many of the exercises in the Building Skills for Career Success feature at the end of each chapter require critical thinking.
<b>7. Prepare for the examinations</b>	Allow enough time to review the material before the examinations. Check out the concept check questions at the end of each major section in the chapter and the summary at the end of the chapter. Then use the resources on the text website.

## Concept Check

- ✓ What reasons would you give if you were advising someone to study business?
- ✓ What factors affect a person's choice of careers?
- ✓ Once you have a job, what steps can you take to be successful?

### Learning Objective

1-2 Define *business* and identify potential risks and rewards.

Because a text should always be evaluated by the students and professors who use it, we would welcome and sincerely appreciate your comments and suggestions. Please feel free to contact us by using one of the following e-mail addresses:

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## 1-2 BUSINESS: A DEFINITION

**Business** is the organized effort of individuals to produce and sell, for a profit, the goods and services that satisfy society's needs. The general term *business* refers to all such efforts within a society (as in "American business"). However, a *business* is a particular organization, such as Kraft Foods, Inc., or Cracker Barrel Old Country Stores. To be successful, a business must perform three activities. It must be organized, it must satisfy needs, and it must earn a profit.

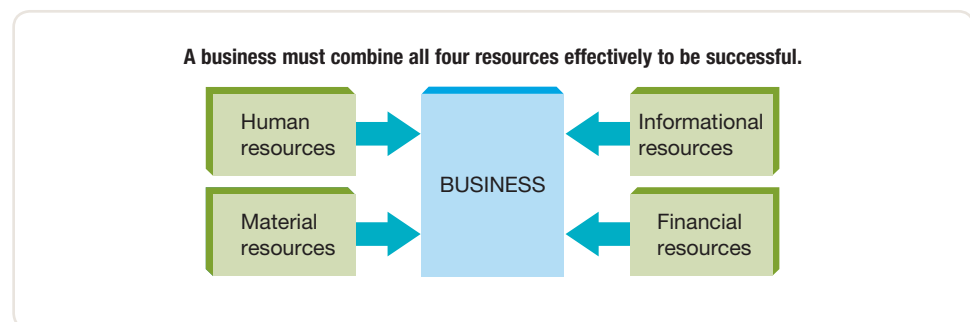
### 1-2a The Organized Effort of Individuals

For a business to be organized, it must combine four kinds of resources: material, human, financial, and informational. *Material* resources include the raw materials used in manufacturing processes as well as buildings and machinery. For example, Mrs. Fields Cookies needs flour, sugar, butter, eggs, and other raw materials to produce the food products it sells worldwide. In addition, this Colorado-based company needs human, financial, and informational resources. *Human* resources are the people who furnish their labor to the business in return for wages. The *financial* resource is the money required to pay employees, purchase materials, and generally keep the business operating. *Information* is the resource that tells the managers of the business how effectively the other three resources are being combined and used (see Figure 1-2).

Today, businesses are usually organized as one of three specific types. *Service businesses* produce services, such as haircuts, legal advice, or tax preparation. H&R Block provides tax preparation, retail banking, and software and digital products to both businesses and consumers in the United States, Canada, and Australia. *Manufacturing businesses* process various materials into tangible goods, such as delivery trucks, towels, or computers. Intel, for example, produces computer chips that, in turn, are sold to companies that manufacture computers. Finally, some firms called *marketing intermediaries* buy products from manufacturers and then resell them. Sony Corporation is a manufacturer that produces stereo equipment, televisions, and other electronic products. These products may be sold to a marketing intermediary—often referred to as a retailer—such as Best Buy or Walmart, which then resells the manufactured goods to consumers in their retail stores.

**business** the organized effort of individuals to produce and sell, for a profit, the goods and services that satisfy society's needs

**FIGURE 1-2** Combining Resources



While most people think of retailers as the “store around the corner,” today many consumers prefer to shop online. To take advantage of the opportunities to sell goods and services online, there are retailers that exist only on the Internet and more traditional business firms that sell goods and services in both their brick-and-mortar stores *and* online. For example, Zappos, a highly successful Internet retailer, only sells merchandise online. Macy’s, on the other hand, sells merchandise in both its stores and online. According to market research, the number of people shopping online and using e-business to shop for goods and services continues to grow each year. For our purposes, **e-business** can be defined as the organized effort of individuals to produce and sell for a profit, the goods and services that satisfy society’s needs *through the facilities available on the Internet*. e-Business—a topic we will continue to explore throughout this text—has become an accepted method of conducting business and a way for businesses to increase sales and profits and reduce expenses.

## 1-2b Satisfying Needs

The ultimate objective of every firm must be to satisfy the needs of its customers. People generally do not buy goods and services simply to own them; they buy goods and services to satisfy particular needs. Some of us may feel that the need for transportation is best satisfied by an air-conditioned BMW with navigation system, stereo system, heated and cooled seats, automatic transmission, power windows, and remote-control side mirrors. Others may believe that a Chevrolet Sonic with a stick shift will do just fine. Both products are available to those who want them, along with a wide variety of other products that satisfy the need for transportation.

When firms lose sight of their customers’ needs, they are likely to find the going rough. However, when businesses understand their customers’ needs and work to satisfy those needs, they are usually successful. Back in 1962, Sam Walton opened his first discount store in Rogers, Arkansas. Although the original store was quite different from the Walmart Superstores you see today, the basic ideas of providing customer service and offering goods that satisfied needs at low prices are part of the reason why this firm has grown to become the largest retailer in the world.

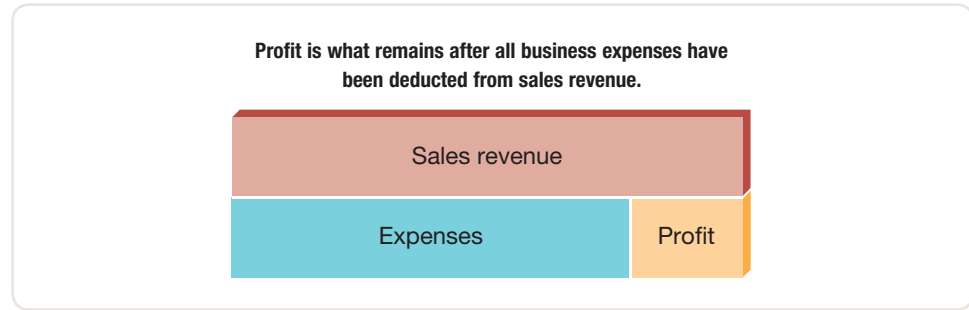
**e-business** the organized effort of individuals to produce and sell for a profit, the goods and services that satisfy society’s needs *through the facilities available on the Internet*.



**Some companies just do it right!** Starbucks, a company that was started in 1971, has established a history of meeting the needs of its customers. Over the years, the company has grown to be the largest coffeehouse in the world with 20,000 stores in 65 countries. Perhaps the reason for its success is its mission to inspire and nurture the human spirit—one person, one cup, and one neighborhood at a time.

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**FIGURE 1-3** The Relationship Between Sales Revenue and Profit



### 1-2c Business Profit

A business receives money (sales revenue) from its customers in exchange for goods or services. It must also pay out money to cover the expenses involved in doing business. If the firm's sales revenues are greater than its expenses, it has earned a profit. More specifically, as shown in Figure 1-3, **profit** is what remains after all business expenses have been deducted from sales revenue.

A negative profit, which results when a firm's expenses are greater than its sales revenue, is called a *loss*. A business cannot continue to operate at a loss for an indefinite period of time. Management and employees must find some way to increase sales revenues and reduce expenses to return to profitability. If some specific actions are not taken to eliminate losses, a firm may be forced to close its doors or file for bankruptcy protection. Although many people—especially stockholders and business owners—believe that profit is literally the bottom line or most important goal for a business, many stakeholders may be just as concerned about a firm's social responsibility record. The term **stakeholders** is used to describe all the different people or groups of people who are affected by an organization's policies, decisions, and activities. Many corporations, for example, are careful to point out their efforts to sustain the planet, participate in the green ecological movement, and help people to live better lives in an annual social responsibility report. In its latest social responsibility report, General Mills describes how it contributes \$153 million each year to a wide variety of causes, including support for programs that feed the hungry and nonprofit organizations, schools, and communities in the United States and around the globe.<sup>6</sup>

The profit earned by a business becomes the property of its owners. Thus, in one sense, profit is the reward business owners receive for producing goods and services that customers want. Profit is also the payment that business owners receive for assuming the considerable risks of business ownership. One of these is the risk of not being paid. Everyone else—employees, suppliers, and lenders—must be paid before the owners.

A second risk that owners undertake is the risk of losing whatever they have invested into the business. A business that cannot earn a profit is very likely to fail, in which case the owners lose whatever money, effort, and time they have invested.

To satisfy society's needs and make a profit, a business must operate within the parameters of a nation's economic system. In the next section, we define economics and describe two different types of economic systems.

**profit** what remains after all business expenses have been deducted from sales revenue

**stakeholders** all the different people or groups of people who are affected by an organization's policies, decisions, and activities

**economics** the study of how wealth is created and distributed

### Concept Check

- ✓ Describe the four resources that must be combined to organize and operate a business.
- ✓ What is the difference between a manufacturing business, a service business, and a marketing intermediary?
- ✓ Explain the relationship among profit, business risk, and the satisfaction of customers' needs.

### Learning Objective

**1-3** Define *economics* and describe the two types of economic systems: capitalism and command economy.

## 1-3 TYPES OF ECONOMIC SYSTEMS

**Economics** is the study of how wealth is created and distributed. By *wealth*, we mean "anything of value," including the goods and services produced and sold by business. *How wealth is distributed* simply means "who gets what." Experts often use economics to explain the choices we make and how these choices change as we cope with

the demands of everyday life. In simple terms, individuals, businesses, governments, and society must make decisions that reflect what is important to each group at a particular time. For example, suppose you want to take a weekend trip to some exotic vacation spot, and you also want to begin an investment program. Because of your financial resources, though, you cannot do both, so you must decide what is most important. Business firms, governments, and to some extent society face the same types of decisions. Each group must deal with scarcity when making important decisions. In this case, *scarcity* means “lack of resources”—money, time, natural resources, and so on—that are needed to satisfy a want or need.

Today, experts often study economic problems from two different perspectives: microeconomics and macroeconomics. **Microeconomics** is the study of the decisions made by individuals and businesses. Microeconomics, for example, examines how the prices of homes affect the number of homes individuals will buy. On the other hand, **macroeconomics** is the study of the national economy and the global economy. Macroeconomics examines the economic effect of national income, unemployment, inflation, taxes, government spending, interest rates, and similar factors on a nation and society.

The decisions that individuals, business firms, government, and society make, and the way in which people deal with the creation and distribution of wealth determine the kind of economic system, or **economy**, that a nation has.

Over the years, the economic systems of the world have differed in essentially two ways: (1) the ownership of the factors of production and (2) how they answer four basic economic questions that direct a nation’s economic activity.

**Factors of production** are the resources used to produce goods and services. There are four such factors:

- **Land and natural resources**—elements that can be used in the production process to make appliances, automobiles, and other products. Typical examples include crude oil, forests, minerals, land, water, and even air.
- **Labor**—the time and effort that we use to produce goods and services. It includes human resources such as managers and employees.
- **Capital**—the money, facilities, equipment, and machines used in the operation of organizations. Although most people think of capital as just money, it can also be the manufacturing equipment in a Pepperidge Farm production facility or a computer used in the corporate offices of McDonald’s.
- **Entrepreneurship**—the activity that organizes land and natural resources, labor, and capital. It is the willingness to take risks and the knowledge and ability to use the other factors of production efficiently. An **entrepreneur** is a person who risks his or her time, effort, and money to start and operate a business.

A nation’s economic system significantly affects all the economic activities of individuals, businesses, government, and society within a country. This far-reaching impact becomes more apparent when we consider that a country’s economic system determines how the factors of production are used to meet the needs of society. Today, two different economic systems exist: capitalism and command economies. The way



**What does it take to be a successful entrepreneur?** Although some people think the life of an entrepreneur is easy, think again. To be successful, entrepreneurs—often referred to as risk takers—must work hard and put in long hours. And they must have an idea for a product or service that has the potential to be successful. Then they must be able to create a plan to turn the idea into a successful product or service.

**microeconomics** the study of the decisions made by individuals and businesses

**macroeconomics** the study of the national economy and the global economy

**economy** the way in which people deal with the creation and distribution of wealth

**factors of production** resources used to produce goods and services

**entrepreneur** a person who risks time, effort, and money to start and operate a business

**New energy from an old source: The wind.** To protect the environment and our natural resources as well as to reduce our dependence on oil, many utility companies are developing alternative energy sources such as wind power. Although the price of oil and gasoline has dropped and the production of oil and gas has increased, once developed, wind-energy may actually be cheaper than using oil in the future.

NIVEK NESLO/PHOTODISC/GETTY IMAGES



each system answers the four basic economic questions listed here determines a nation's economy.

1. *What* goods and services—and how much of each—will be produced?
2. *How* will these goods and services be produced?
3. *For whom* will these goods and services be produced?
4. *Who* owns and who controls the major factors of production?

### 1-3a Capitalism

**Capitalism** is an economic system in which individuals own and operate the majority of businesses that provide goods and services. Capitalism stems from the theories of the Scottish economist Adam Smith. In his book *Wealth of Nations*, published in 1776, Smith argued that a society's interests are best served when the individuals within that society are allowed to pursue their own self-interest. According to Smith, when individuals act to improve their own fortunes, they indirectly promote the good of their community and the people in that community. Smith went on to call this concept the "invisible hand." The **invisible hand** is a term created by Adam Smith to describe how an individual's own personal gain benefits others and a nation's economy. For example, the only way a small-business owner who produces shoes can increase personal wealth is to sell shoes to customers. To become even more prosperous, the small-business owner must hire workers to produce even more shoes. According to the invisible hand, people in the small-business owner's community not only would have shoes but also would have jobs working for the shoemaker. Thus, the success of people in the community and, to some extent, the nation's economy are tied indirectly to the success of the small-business owner.

Adam Smith's capitalism is based on the following fundamental issues—also see Figure 1-4.

1. The creation of wealth is the concern of private individuals, not the government.
2. Individuals must own private property and the resources used to create wealth.
3. Economic freedom ensures the existence of competitive markets that allow both sellers and buyers to enter and leave the market as they choose.

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

**invisible hand** a term created by Adam Smith to describe how an individual's personal gain benefits others and a nation's economy