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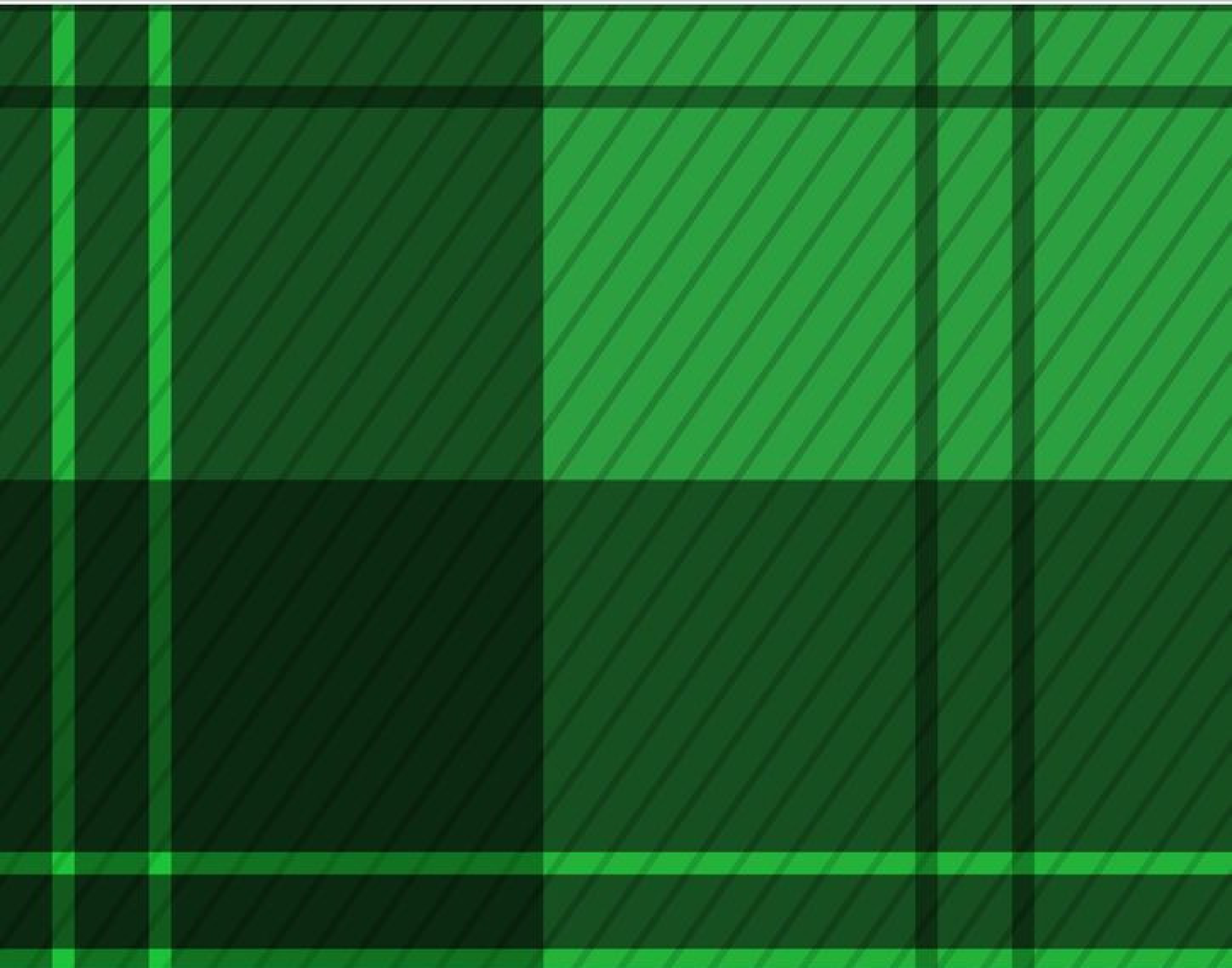
Larissa Zaplatinskaia

Fascinating economy



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This book is an academic course in international economics for university students. The study of economics is important because the economy — global, national, local, and personal — effects what you do every day. Economics influences the work you do, where you live, what you eat, how you dress, whether there is gas available for your car, and more. Economics also influences government policy and international relations including wars.

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Fascinating economy
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Chapter 1

You may never have thought of it this way, but in some ways, economics is like a game. Games have players and rules. Games involve decisions and actions, and they always have a goal. The same is true about economics.

Still, there are some differences. In games, you typically get to decide whether you want to play. But no one ever asks you if you want to play the game of economics. In this game, you play whether you want to or not. That is because the game of economics is going on all the time. It is played at every second of every day in all parts of the world.

Since you are already playing the game of economics, you should know what kind of game it is and learn the rules. That way you can play it as well as possible.

Introduction

The study of economics is important because the economy – global, national, local, and personal – effects what you do every day. Economics influences the work you do, where you live, what you eat, how you dress, whether there is gas available for your car, and more. Economics also influences government policy and international relations including wars.

Understanding the basics of economics will help you make good personal financial choices and will help you make wise environmental and political decisions, as well.

We will start by learning that economics is not a collection of «other» people but a complex system in which every individual has roles and goals.

We will also explain the four fundamental questions of economics and how, depending on the way these questions are answered, the game changes. Very soon, you will be well on your way to understanding what the economy is all about and how it relates to your everyday life.

Some games are similar to each other. Take basketball and soccer, for instance. They both have two sides consisting of a set number of players. There are specific ways to score points. There is a winner at the end of a set amount of time. So, although basketball and soccer are different games, they have much in common.

But what about checkers and soccer? Maybe there are one or two similarities, but the ways to win are very different. In soccer, the team that scores more points wins. In checkers, a player who takes all his or her opponent's pieces is the winner.

Is there anything that is the same in every kind of game?

Playing by the Rules

Are there any games that allow players to do whatever they want? No. All games have rules. There are important rules in economics, too.

In economics, the rules are usually laws. Laws are rules that define what is and is not allowed. For example, you cannot steal from others. That is a law, and it is also one of the rules of economics. Another law is that exchanges must be voluntary. Consumers cannot be forced to buy things. Voluntary exchange is a rule of economics, and it is also a law.

Rules and Properties

Games require that people play by certain rules, but that is not all there is to games. Games are fun precisely because there is more to them than just the rules.

In tag, we all know to avoid the person who is «it.» This is not a rule. There is no penalty if we do not follow it. But even though it is not a rule, it has an effect on how the game is played.

Anything that is not a rule but still affects how a game is played is called a property. The properties of a game follow naturally from the rules, but they also add something to the game that goes beyond the rules. This is how economics works.

Economic Properties

Like all games, economics has properties in addition to the rules. These properties affect how the game is played.

Remember: One of the rules of economics is «no stealing.» If you want to make an exchange, the buyer and seller have to agree on the price and then make the exchange. The rule, however, does not tell you how much the price will be. It could be any amount.

This is not true for all games. In Monopoly, prices are set by the rules. A railroad costs $200. But in economics, unless there is a specific law that sets the price, the amount is up to the buyer and seller.

How do prices get set if the rules do not set them? One of the properties of economics helps: Buy low, sell high.

Why is this a property of economics? The buyer is giving up something good: money. So, the buyer usually wants to pay as little as possible. The seller, on the other hand, wants to get as much money as possible. Buyers want lower prices, and sellers want higher prices. Hence, buy low, sell high.

While almost all buyers and sellers play the game like this, it is not a rule. You do not go to jail if you sell something for a lower price than you could have. You are not a criminal if you pay more for something than you have to.

In economics, there are a lot of properties. Sometimes, economists call them «laws,» but they are not laws like «no stealing» is a law. They are properties, like «buy low, sell high.»

One of these properties is called «The Law of Supply and Demand.» Despite the name, «The Law of Supply and Demand» is actually a property, not a law. This property can be complicated, but one part of it states that when the supply of something is low and the demand is high, then the price will be high. Why? It is related to the «buy low, sell high» property.

Let us say someone has a rare object, like one of the few original copies of the Declaration of Independence. What if you wanted to buy that rare object? You cannot steal it. That is a rule. And as a buyer, you want to pay as little as possible.

So, you offer a low price. But there are other buyers, too. If you want to buy this rare copy of the Declaration of Independence, you have to compete with the other buyers. Someone else also wants it badly, so they offer more than you. Now, you cannot go somewhere else to buy because it is rare. If you want it, you have to offer more. So, you do. But the other person offers more than you again. The price is going higher and higher. Why? Because of the «Law of Supply and Demand.»

No one is forced to obey this «law.» There is no Supply-and-Demand Police making sure this happens, but it happens all the time. Economists call this «The Law of Supply and Demand» instead of «The Property of Supply and Demand» because nearly everyone obeys it even though it is not actually a rule.

Outcomes

There is another feature common to all games. Every game has an outcome. Outcomes are the real heart of any game.

Outcomes also take place throughout the playing of a game. They result from plays or moves, but the idea is the same – one thing results in another.

Economics has many outcomes. A sale is a common example. When someone buys something, and the item and money change hands, that is an outcome. Later, we will take a look at other economic outcomes.

And the Winner Is – No One?

So far, we have seen that all games have certain features:

- Players
- Rules
- Properties
- Outcomes

It seems as if there is one more thing that is common to all games: a winner. Does an activity need a winner to be considered a game? Not necessarily.

Consider the game of tag. The players in tag are either «it» or «not it.» Which one is the winner? Do you win if you are not it? No, you are just one of the players who are not it. And being it does not make you the loser. You are just it until you tag someone else.

Tag has no winner because there is no rule that states when the game has to end. A game of tag does not end when somebody wins. It lasts until all the players decide to stop playing. Technically, a game of tag could go on forever. The same is true for economics.

Winners often get medals or trophies to show that they have won.

The Features of Games

To study economics, you need to understand how the various features of the game work. This means knowing about the different roles of the players and the rules they have to obey. It also means knowing about outcomes and understanding the properties that affect the way the game is played.

Economics is like a game. It has many of the attributes that all games have in common: players, rules, properties, and outcomes. But what kind of game is it? What do the players do?

Surprisingly, the answer is simple: Economics is a game in which players buy and sell goods and services. It has rules, properties, and outcomes that limit and direct how all that buying and selling takes place.

Goods and Services

Objects that fulfill someone's needs and wants are called goods. You need food. A sandwich is a good that fulfills that need. Every time you buy a sandwich, you are a player in the game of economics.

What about things you want? Do you want to surf the Internet? A computer fulfills that want. A computer is a good. A DVD fulfills the want for entertainment, so it is a good, too. Just about every object fulfills some need or want.

All foods are goods, even if they do not taste good.

Sometimes our wants and needs cannot be fulfilled by goods, or objects. In that case, we might require a service. Services are actions or other types of assistance that customers need and want.

For example, when you need a trim, or you want to change your style, you get a haircut. But a haircut it is not an object. It is a service. Someone with a specific skill works to give you the trim you need or the style you want. Your stylist performs an action, or a service. However, he or she makes use of goods, such as scissors and a comb, to perform the service.

Giving someone a haircut is a service that requires goods like scissors and a comb.

Is Economics About Everything?

Not everything is a good or a service. For instance, when you pay someone to mow your lawn, you are buying a service. But when you mow your own lawn, you are just making the grass shorter.

In other words, an action that you perform for your own benefit is not a service. If you read a book, you are not doing anybody a service. You may be relaxing or learning. These are good things, but they are not services because you do them for yourself.

On the other hand, if you read a book out loud to somebody else, you are performing a service. A service is still a service even if someone offers it for free, but services rendered generally involve the exchange of money. The exchange might also be made using the barter system.

What Is Production?

Goods and services need to be made. This is known as production. Production is one of the things certain players in the game of economics do. A player who does this is known as a producer.

Production does not just happen. There are required to produce goods and services. Something needed for production is called a resource.

For example, you need flour to make a cake. The cake is a good, and the flour is a resource. Where did the flour come from? Originally, it came from a wheat field. So, the wheat field is a resource, too.

What It Takes to Make a Birthday Cake?

Let us say you want to make a birthday cake for someone. That is a service. It takes action to make a cake, and this action is valued. And it produces a good – a birthday cake. One of the main services in any economy is making goods. This service, called production, requires all kinds of resources. To make a cake, you need a kitchen. A kitchen is a resource.

Of course, you also need the stuff you make the good out of. If you are making a cake, you need flour and eggs and sugar and everything else in the recipe. These are some of the resources you need to make the cake. But you also need bowls, spoons, measuring cups, and a pan. These are

resources, too. And finally, you need time and knowledge. In the end, you will put in a lot of effort. All of these things – time, knowledge, and effort – are resources.

Even a genie, who can make a birthday cake out of thin air, has to do something. Maybe the only action they have to take is saying, «Abracadabra.» But that still takes up the genie's time and requires genie powers. Time and genie powers are resources. Even a genie needs some resources to produce a birthday cake.

Allocation

Resources are essential for production. But very few resources are easily available and ready to be used. Resources need to be found and set aside to produce specific goods. That is known as allocation.

Allocation involves making decisions. If you have a bag of flour, you have to decide whether you want to make cake or bread. That is a decision about the allocation of this resource.

Economics is a game of constant decision making. A lot of these decisions have to do with allocation.

Making decisions about how to allocate resources is part of many games, not just economics. A softball coach allocates players by deciding who plays what position and making the batting order.

What will you do with your flour?

Distribution and Consumption

Economics is about the allocation of resources to produce goods, but what do we do with these goods once they are produced? We use them, of course.

Using a good or a service is known as consumption. In the game of economics, people consume goods that are produced. When a player uses a good or service, he or she is known as a consumer.

Goods are rarely produced where they are used. If you have a piece of clothing with a label that says «Made in China,» it had to travel a long way to get to you.

Moving goods to consumers is known as distribution. Producers have to distribute goods to the people who want to consume them. Resources get distributed, too.

Perhaps you want to bake a friend a birthday cake, so you buy a bag of flour. Think of all the distribution the flour has to go through to get to you:

It starts out as wheat in a field far away. After harvest, it is sent to a flour mill. This takes resources, such as a truck, gasoline, and a driver. When the milled flour gets loaded onto another truck to be shipped to a warehouse, it takes more resources. From the warehouse, the flour is loaded onto more delivery trucks and taken to the store, requiring still more resources. Finally, the bag of flour has arrived at the store for you to buy. You become the final stage of distribution when you take the flour from the store to your kitchen.

Producing goods takes resources, and so does distributing them. You need trucks and trains and ships, and they need gas and tires and so on. These resources have to be allocated, as well. So, in addition to the allocation of resources for producing goods and services, economics is also about allocating resources for distribution.

Many goods that we use in the United States are made in other countries.

So, what is Economics About, Again?

You have seen that economics is about producing goods and services for people to consume. You have also seen that production requires resources, as well as decisions about the allocation of these resources. Finally, you saw that goods and resources need to be distributed from where they are produced to where they are used. If you put all of this together, you should have a good idea of what the game of economics is about.

Goals are a big part of economics. They help us avoid uncertainty. Goals also help us make crucial decisions.

Imagine you are playing softball. You know the rules, but you still have many decisions to make. Should you pitch a curveball or a fastball? Should you swing at a ball, or wait for a better pitch? Should you steal second base, or wait on first? Without a goal, it would be hard to answer these questions.

If you have a goal, the answers are obvious. If your goal is to win the game, you know what to do – throw your best pitch, try hard to hit the ball, and steal as many bases as you can without getting thrown out. These are the things that players need to do to win.

Economic Goals

In the game of economics, you need goals to avoid confusion and to know what to do with yourself. Different people have different goals, however. You may think the only goal in economics is to make money, but there are many different goals in economics.

Different economic goals affect how people approach making decisions in the game of economics. If your goal is efficiency, it is likely that you are going to allocate resources for the production and distribution of goods and services differently than a person whose goal is security or freedom.

Read through the list to see the different economic goals that people pursue. Each will be defined in the coming pages.

Goals for Playing the Game of Economics

1. Efficiency
2. Growth
3. Security
4. Equity
5. Freedom

Efficiency, Growth, and Security

The first three economic goals – efficiency, growth, and security – are goals that make a lot of sense. But that does not mean that everyone agrees these are the proper goals to pursue when deciding how to allocate resources.

• Efficiency refers to the use of resources in a manner that gets as much out of them as possible. Efficiency is a goal producer have, to provide more goods and services for society without using more resources.

• Growth means increasing the size, number, or output of goods or services. It makes sense to want growth, because in the economy, growth means more goods, more jobs, and more money.

• Security is protection against risk or danger. Because life is uncertain and bad things can happen, the economic goal of security encourages us to lessen the dangers we face.

It is Not Fair

Another economic goal is equity. Equity means fairness; It is the notion that everyone should be treated equally. If a game is not played fairly, then the outcome will be unfair. When a game is fair, it has equity.

Still, equity can be a tricky concept. Different people might have different ideas about what is fair. Also, it is not always clear what is fair in a particular situation. Is it fair that one person has a lot while someone else has nothing?

Questions of fairness are not always easy to answer. Maybe the person with less does not deserve more. Consider the fable of the ant and the grasshopper.

The Ant and the Grasshopper

The ant worked hard all summer, building a house, and stocking up on supplies for the winter. The grasshopper danced and played the summer away. When the winter came, the ant had plenty of food to survive. The grasshopper had no food and died of starvation.

What is Fair?

Competing ideas about what is fair is a common problem when pursuing the goal of equity. This makes equity a problematic goal for economics. Although equity is a good thing to pursue, it is rarely obvious how to achieve it.

At the end of the story on the previous page, the grasshopper had nothing, and the ant had plenty. Is that fair? It depends on your perspective.

View the Ant and the Grasshopper to hear each side of the story, from the ant's industriousness to the grasshopper's cluelessness.

I'm sad that the grasshopper did not know what to do to prepare for winter, but I do not think it is fair to take food from me to help keep him alive. That would be rewarding the grasshopper for his lack of foresight and punishing me for my industriousness. It is not fair to punish someone for doing the right thing.

I do not think it is fair that I should have to starve. I have never seen the winter before, so I did not know what would happen. No one told me I would have to build a house and gather supplies. Do I deserve to die in the cold because I did not know about the harsh conditions I would have to face? Since I did not know, it is not fair to let me die. Would not it be fair to take some of the ant's food to help me out?

Let Freedom Ring

Another important economic goal is freedom. Just like equity, however, freedom is a tricky concept. It can mean different things to different people.

Freedom in economics is defined as the absence of an obstacle or constraint. But what is the obstacle or constraint, and how can it be removed? Different obstacles and constraints present themselves to different people in innumerable situations.

The Statue of Liberty represents freedom, but not everyone defines freedom the same way.

The Two Faces of Freedom

It is normal for people to have different ideas about freedom. Freedom is the absence of an obstacle, but the obstacles people face are not always the same, so their ideas about freedom can be very different.

For a teenager, one obstacle might be rules set by one's parents. For a parent, an obstacle to freedom might be his or her struggle to earn money for the family.

In the game of economics, different ideas about freedom lead to different ways of looking at the allocation of resources. If you think of freedom in terms of people making their own choices, you might believe that producers should get to decide how goods and services are produced without any constraints. But if you think of freedom as the absence of economic struggle and need, you might believe the government should tell the producers what to make and how much to charge so that everyone's basic needs can be met. These different views of economic freedom lead to different ideas about how an economy should function.

Conflict Over Goals

With goals that are sometimes incompatible, economics can lead to conflict. Do you want efficiency, growth, security, equity, freedom, or some combination? You need to have some goals, but someone else will inevitably have different goals. No matter what you want, there are bound to be other people who want something else. This can create conflict.

This means that there is more to economics than the allocation of resources for the production and distribution of goods and services. Economics is also about setting goals that affect how these allocation decisions are made.

We All Need Goals

You cannot play a game without goals. How else can you make important decisions? But people often disagree about the goals they have for playing a game.

Things are no different in the game of economics. The goals people have for the economy might be different. They might even be incompatible sometimes. Nevertheless, you need goals to play this or any game.

Humans have wants and needs that are often greater than what is available. Thus, people face scarcity as a basic fact of life.

You might think that there are plenty of goods and services available to you. But what would happen if the world stopped producing the thing you need or want? Eventually, the supply would run out. When goods and services become hard to find, it leads to scarcity.

You saw before that economics is about the allocation of resources for the production and distribution of goods and services. The problem of scarcity is the reason that this is necessary. If there were plenty of goods and services to go around, no one would need to make allocation decisions. Scarcity is yet another reason why everyone plays economics.

People can face shortages of important goods.

What Is to Be Produced?

Because scarcity is a fact of life, people have to work to try to increase supply in order to meet demand. Different people want different goods and services. If there were unlimited resources, people everywhere could have what they wanted.

Since resources are not unlimited everyone has to make tough decisions about what to do with the resources available. One big question that needs to be addressed in any economy is this: What is to be produced?

Because of scarcity, deciding what is to be produced involves also deciding what not to produce.

Remember your bag of flour? You can allocate the flour for making bread for sandwiches. But what if it is your friend's birthday? If you use the flour for bread, you cannot make a birthday cake. Before you start producing something, you have to decide what to produce.

Allocating resources often involves deciding to produce one thing instead of another.

Getting Organized

Once it is decided what will be produced, there are still more questions to answer. It takes organization to produce and distribute goods and services.

There are all kinds of ways to organize production. There could be factories, offices of varying sizes, or people working at home. There could be different people who specialize in different jobs, or everyone could take turns doing all the different jobs. Production might go on 24 hours a day, seven days a week, or it could be kept to certain working hours.

This is just a short list of the different options. There are many methods of organizing production. How do people decide on the best way to organize production? The economic goals people have will affect how this question is answered. This can again lead to conflict.

The goal of efficiency requires a form of organization that has as little waste as possible. One good way of eliminating waste is to have different workers specialize in different jobs. But if equity is the goal, specialization might not be the way to go. When you divide up production into different tasks, some of the tasks might be harder than others. Equity could mean giving each of these workers a chance to do the easier, cleaner job. But what if freedom is your main economic goal? In this case, production would have to be organized to give workers different choices, and workers would have the freedom to decide what jobs to take.

Who Gets What and Where?

The questions do not stop once decisions about production have been made. You saw that goods often need to be transported from where they are made to where they are used. This is distribution. There is more to distribution than just transportation, however.

Getting goods to the people who use them means making decisions about who gets what. Because of scarcity, some people will not always get what they want. So, the game of economics involves answering a third question: How are goods and services to be distributed?

In other words, how shall we decide who gets what?

If you want equity or security, producers probably need to be told what to produce. Their choices could end up being incompatible with those goals. The government can make sure that everyone is secure, or that goods and services are distributed fairly. But when the government decides how goods and services are distributed, that takes away free choice. Producers are told what to produce and where to send it. A different way to organize distribution is not to organize it at all, to leave it up to people's free choices to decide what gets produced and how goods and services are distributed. This might result in an unfair distribution, or one that leaves some people insecure, but it would not involve the government telling people what to do.

A Variety of Resources

Organizing an economic system involves making decisions about what is going to be produced and how it should be distributed. That takes care of most of the game of economics.

Still, there is one final question to be answered: What is the most effective allocation of resources?

There are all kinds of resources that go into production and distribution. Remember all the resources needed to make a birthday cake? There are a lot of them: an oven, a timer, ingredients, utensils, time, knowledge, and effort.

Production and distribution usually involve a long list with very different types of resources. The flour needed for the batter is a different type of resource than the oven needed to bake the batter, or the time needed for the whole process.

Deciding how to allocate resources means you have to pay attention to where the different resources come from.

It takes many different resources to make a cake.

The Factors of Production

The types of resources needed for production are known as the factors of production. There are three different factors of production: land (in economics, the term land refers to any natural resource on, under, or over the land), labor, and capital.

Land is useful for making things. Fields are used to grow food, and water or wind can be used to produce energy. And land is not just what you see on the surface of the Earth. It also includes things that can be found underground. Things like coal and iron – even steam and water come from underground. These natural resources are all useful for producing things.

Some goods spring directly from the Earth, but it takes some work on the part of humans to make all goods. Even a wild blackberry has to be picked by someone before it can be eaten. All production requires a human touch. Labor is the work that humans do to take natural resources and turn them into useful products. Sometimes the labor is physical. Sometimes the labor involves coming up with ideas. Whatever form labor takes, these human resources are just as necessary as natural resources.

Capital is the final type of resource needed for production. Capital resources are goods that have been produced by humans to make more goods. Capital includes machines like bulldozers and cement trucks. It also includes buildings like factories and other structures such as dams and oil wells.

The term capital also refers to the money used to pay for other resources. Like other forms of capital, money has been created by humans to help with the process of production.

You can see that playing the game of economics involves answering a lot of different questions. There are four fundamental questions faced by people in all economic systems.

The way these four questions are answered tells you a lot about the way decisions are made in different economic systems. When these questions are answered in different ways, you end up playing different games.

Another major element in economics is the concept of supply and demand. The fundamentals of supply and demand change depending on what type of economic system you are dealing with, however, so this concept cannot be included in the fundamental questions of economics, in general.

The Four Fundamental Questions

1. What is to be produced?
2. How is production to be organized?
3. How are goods and services to be distributed?
4. What is the most effective allocation of resources?

You have seen that there are different economic goals that can be pursued: efficiency, growth, security, equity, and freedom. It can be difficult to decide among them.

Individual people are not the only ones who choose economic goals. Entire societies also make the same choices. If it is hard enough to choose for yourself, imagine how hard it is for a whole society to agree on its economic goals! To make this decision, it helps to understand the different results that occur from pursuing different goals.

For example, what would the game look like if everyone agreed that freedom was the most important goal? To answer this, you can look at how a society that values freedom would answer the four fundamental questions of economics. This tells you what a free-market system looks like.

The free-market system, sometimes referred to as capitalism, is one of the most common economic systems on Earth. Examine how it works.

Free Choice

The first question raised by scarcity: What will be produced?

When you are alone, you can answer the question based simply on your personal needs or wants. When an entire society decides what will be produced, however, it raises a different question first: Who within society gets to make the decision? This question needs to be asked and answered before the first fundamental question.

It might seem obvious that the producers themselves should get to decide what to produce. Their role is to produce goods and services, so it makes sense to let them choose. This is exactly what happens in a free-market system: Producers are free to choose what to produce.

Producers also get to choose how to organize production, which addresses the second question. In fact, producers are free to answer all four of the fundamental questions without anyone telling them what they have to do. A capitalist society is one where allocation, production, and distribution are organized by the free choices of the producers.

The Customer Is Always Right

Capitalism leaves production decisions up to the producers, but the choices made by consumers also play an important role. Producers must eventually sell their goods and services to consumers. In a free-market system, consumers have the freedom to choose what to buy. This gives them a lot of power over producers.

Producers want the goods and services they make to be purchased and used. That means producers must pay attention to what consumers need and want. If consumers choose not to buy the goods and services they produce, the producers have to make different decisions.

Because of this, the needs and wants of consumers influence the decisions of producers. In a free-market economy, the free choices of both producers and consumers determine how the fundamental questions are answered.

Go with the Flow

A free-market system is based on the free choices of producers and consumers. The choices one group makes affect the other group. Consumers can only consume what producers produce. At the same time, producers want to make only what consumers need and want.

Because of this back-and-forth influence, capitalism has a circular flow. Influences and inputs move between producers and consumers. Economists call this a circular-flow model.

View the Circular-Flow Model below to see the circular-flow model of the free-market system.

The Circular Flow Model

The main players in the free-market game are producers and consumers. There is a circular flow of influences and inputs between them. A circle has no beginning and no end, so there is no first influence or input – but we need to begin somewhere, so let us start with the producers. Producers make goods and provide services. These go to the consumers to be used. The consumers purchase these goods and services. Consumers also provide the factors of production by working and investing. Producers pay for the work with wages, and they repay and reward the investments with profits. These things flow back and forth, continuing the cycle as producers and consumers interact and influence each other's decisions.

Defending Freedom

The free-market system is based on producers and consumers making free choices. But often, consumers and producers have desires that conflict.

Conflict results naturally from people's desires, and some people try to resolve conflict by using threats to force people to choose in a certain way. This is called coercion. When your desires conflict with someone else, the other person might try to make up your mind for you by using coercion.

Because the free-market system relies on free choices, coercion is usually forbidden in capitalist societies. It is illegal to take away people's right to choose through coercion. Laws in capitalist societies are designed to defend the freedom of producers and consumers.

The Rules of the Game

There are many ways to take away someone's freedom. Thus, rules are needed to make sure producers and consumers can make free choices. You already know some of these rules. For instance: No stealing.

«No coercion» is another important rule. Coercion can include lying, so «no lying» is also part of the rules of a free-market system.

In economics, the rules are laws. That is why the government passes laws against theft, coercion, and fraud. In a free-market system, the government has to make and enforce whatever laws are needed to guarantee free choice.

Private Property

Maybe you currently have some amount of financial freedom. Maybe you get an allowance, or you have a part-time job that provides a bit of spending money. But what if your allowance was taken away or you lost your job? Then you might have to ask someone else for money. Since the people you ask are free to choose, they can say yes or no.

To be free, you need more than protection against coercion. You need to have resources, too. If you do not have your own resources, then your ability to make free choices is limited.

In a free-market system, individuals get to make free choices about what to do with the resources they have. Therefore, rules protecting private property are among the most important rules of a capitalist society. These rules are referred to as property rights.

Land is one of the resources that helps people be free.

The Resource of Work

Land, money, and capital are resources, but they are not the only resources that allow one to make free choices. Healthy adults who own no property still possess one important resource – their own labor. The ability to work is an important resource in a capitalist system.

The rules of the free-market system protect you against coercion. It is illegal for anyone to force you to do something. This means that the rules guarantee that you can make free choices about how you sell your labor to others.

Labor is an important resource. Almost all production requires some labor. So, everyone who can work has an important resource, the resource of work. Having this resource gives people the ability to make free choices.

Competition

The free-market system relies on free choice and private property, but that is not all. Competition is another important part of capitalism.

Competition is needed to guarantee freedom. Without competition, people do not have a lot of choices. In fact, they might have only a single choice.

Free-market systems have to guarantee that there will be competition. It is one of the rules. Without competition, you would have to take the «free» out of free-market system.

Stock exchange

On the floor of the New York Stock Exchange, traders compete with each other to buy and sell shares.

The Importance of Competition

Imagine that you are hungry, and you want a sandwich. If there are a lot of different sandwich shops in competition with each other, then you will have a lot of choices. In fact, you will probably have fairly good choices. Because you can go to someone else, each shop is competing to get your business. This kind of competition gives the consumer a lot of good choices. They have got a lot of things to freely choose among.

But what if there were only one sandwich vendor? As a consumer, you would have to go to this one sandwich vendor and take what they had. Maybe they only have tuna fish sandwiches that cost $20. You do not even like tuna fish sandwiches, and you definitely do not want to pay $20 for one. But what other choice do you have? You have to buy the $20 tuna-fish sandwich or go hungry. You can always choose no sandwich and starve, but that is not much of a choice, is it? If your freedom consists solely of choosing between something you do not want – an expensive sandwich you won't like – and something else you do not want – starvation – then it is hardly worth calling it freedom. Without competition, consumers do not have the freedom they are supposed to have.

The Profit Motive

Free choice, private property, and competition are at the heart of the free-market system. They are so important that there are rules protecting them.

We saw before that games often have properties in addition to the rules. Such properties are not enforced like rules, but they affect how a game is played. Properties of the free-market system are often called market forces.

One important market force in a capitalist system is the profit motive. Producers make a profit by selling a good or service for more than it costs to produce. The difference between the total cost of production and the selling price is the producer's profit. If the cost is greater, the producer suffers a loss and will struggle to stay in business.

There is no rule that says you have to follow the profit motive because there does not need to be such a rule. It is obvious to any producer that a profit is better than a loss. In the free-market system, the profit motive exists without any kind of coercion.

Profit and Competition

The profit motive is extremely important for the free-market system. Because of competition, efficiency and innovation often result from this drive to make a profit. If you are competing with others, you cannot afford waste. Waste increases costs, which cuts into profit. So producers work hard to be as efficient as possible.

Competition keeps prices low, which means that producers cannot just make up for inefficiency by raising prices. The incentive to be efficient and innovative is an example of market forces.

The profit motive can also work against competition. If you really want to make a lot of money, it would be better not to have any competition. That way, you could sell your goods and services for a much higher price and make more profit. Profit seekers have an incentive to get rid of competitors, if they can, to make more profit. This is another reason it is necessary for the government to make laws protecting competition.

What is So Free About a Free Market?

You have seen that the free-market system is based on free choice, private property, competition, and the profit motive. These rules and properties create one particular version of the game of economics. It is just one version, but it is the game that most societies play.

Advocates of the free-market system might argue that the most important goal is freedom. Freedom is so desirable, they might say, that it makes it worthwhile to sacrifice other goals. Some advocates of the free-market system, however, think that we might not need to make these sacrifices. They believe that pursuing freedom allows us to reach the other goals as well.

Adam Smith was an early advocate of the free-market system. In the same year that the Declaration of Independence was written, he published a book called An Inquiry into the Nature and Causes of the Wealth of Nations. It is often simply called The Wealth of Nations.

Modern free-market advocates often cite Adam Smith to support their claim that freedom is the most important economic goal. Read some of what Smith said so you can judge the claims of the free-market supporters who agree with his reasoning.

Adam Smith is sometimes called the founder of capitalism.

Read the following excerpt from and think about the things that Adam Smith said about the free-market system. *The Wealth of Nations*

As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it ….

The property which every man has in his own labour, as it is the original foundation of all other property, so it is the most sacred and inviolable. The patrimony of a poor man lies in the strength and dexterity of his hands; and to hinder him from employing this strength and dexterity in what manner he thinks proper without injury to his neighbour, is a plain violation of this most sacred property. It is a manifest encroachment upon the just liberty both of the workman, and of those who might be disposed to employ him. As it hinders the one from working at what he thinks proper, so it hinders the others from employing whom they think proper. To judge whether he is fit to be employed, may surely be trusted to the discretion of the employers whose interest it so much concerns. The affected anxiety of the law-giver lest they should employ an improper person, is evidently as impertinent as it is oppressive…

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade

from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary.

The Invisible Hand

An important part of Smith's theory is the «invisible hand.» He did not believe that a literal hand guides economic outcome. The invisible hand is a metaphor or symbol of market forces in the free-market system that lead to good outcomes without any planning. Because of this invisible hand, pursuing freedom helps realize other economic goals such as efficiency, growth, and security.

Smith clearly did not trust governments to direct economic affairs. Individuals pursuing their interests can «judge much better than any statesman or lawgiver can» what is best for the economy. Smith was very suspicious of government intervention in the economy.

Smith was also wary of producers since their pursuit of profit might persuade them to work against competition. That is what he meant by «some contrivance to raise prices.» He recognized that the government has a role to play in the game of economics. He believed that the government's role should be limited to protecting such things as competition, free choice, and private property. The government should not have «folly and presumption enough» to believe it can run the economy directly. According to

Smith The invisible hand is not actually a hand.

It is better for everyone if the economy is left in the hands of private individuals pursuing their own interests. That is the invisible hand at work.

A different ball and different methods of pitching make softball and baseball two different games.

Playing the game of economics involves answering four fundamental questions. When they are answered differently, different games result.

Think about softball and baseball. They are similar games with a few important differences. This is also true for economics. There is more than one way to set up the rules. This means there are different versions of the game of economics.

The four all-important questions are

- What will be produced?
- How should production be organized?
- How will goods and services be distributed?
- What is the most effective allocation of resources?

Do What I Say and What I Do

A command economy has less freedom than a free-market system. Producers have to do what the government says. They do not get to decide what to make or how to make it. Also, people do not get to decide where they will work. The government decides that. This is why it is called a command economy: The government issues a lot of commands.

In a command economy, the government controls everything related to the allocation of resources and the production and distribution of goods and services. In order to do this, the government owns most of the property. Private property is an important feature of the free-market system, but it gets in the way of a command economy.

The following is a long list of government functions in a planned economy. The list goes on and on, but these are the fundamental commands issued in a command economy.

Government Commands

In a command economy, the government

1. Assigns production to producers.
2. Allocates resources to producers.
3. Sets prices for consumers.
4. Decides where people work.
5. Sets wages for workers.

6. Sells goods and services.
7. Decides who gets what and how much.
Your Wish Is the Government's Command

Why would a government do all of this commanding?

There are other economic goals besides freedom and efficiency, and capitalism does not always serve these other goals. The free choices of producers and consumers often result in inequality and insecurity. Growth is sometimes strong and sometimes weak. People may be free to make choices, but they are often not free from struggle and need.

Command economies exist to serve other economic goals, usually equity, security, and freedom from need. These are the main concerns of both socialism and communism. Most nations have some elements of socialism as you will see later, but some countries have attempted complete socialism. Communism combines extreme socialism with political ideology. The former Soviet Union was a communist country. Today, China, North Korea, Vietnam, Laos, and Cuba still have communist governments though most have incorporated elements of capitalism. The philosophical goal of a command economy is to ensure equity and security. But under communism, the reality has been quite different. While some communist economies improved from what they were under previous authoritarian governments, none has achieved true equity or efficiency, and none has reached its economic potential. Some, such as North Korea, have had disastrous economic consequences. Additionally, these governments remain politically repressive.

Making a Plan

Free-market systems and command economies have different goals. But the differences do not end there. For one thing, a command economy has an extra set of players. There are producers and consumers, as in any economic system. There are also government planners. The planners are the ones who issue the commands.

In a free-market system, outcomes are not planned by anybody. They happen because of market forces. The law of supply and demand sets prices. Demand for different types of labor decides where people will work and how much they will make. Voluntary exchanges determine how resources are allocated.

In a command economy, these things are decided by the government instead of by market forces. Planners decide how to allocate resources for the production and distribution of goods and services. This means they decide what gets produced, they organize production, and they also decide which consumers will receive what and how much. In a command economy, planners, not producers, answer the four fundamental questions.

Diverting the Flow

The free-market system operates with a circular flow between producers and consumers. In a command economy, the flow is different because of the important role played by government planners. Their decisions affect almost everything that goes on in the economy.

A game with three sets of players is obviously very different from a game with two sets of players. A command economy has a flow that involves the planners at almost every step.

Remember how the circular flow model of the free-market system works? Inputs and influences go back and forth between producers and consumers. In a command economy, government planners get involved. What they do changes the flow. Goods and services are purchased from the government, and the money paid returns in the form of wages. Profit is eliminated. Diverting the flow of the free market this way tends to slow things down.

In a command economy, planners have to figure out what resources are needed to reach their society's goals, and they have to figure out how to organize production. Collecting information and coordinating decisions use up a lot of labor, so there are fewer workers to contribute to production. This limits growth. The command economy also cuts down on efficiency and innovation. Planners

are focused on organizing resources to meet society's goals. They do not have much time or incentive to come up with the new products or different ways of doing things.

The Land of the (Mostly) Free Market

You have examined two different economic systems: the free-market system and the command economy. Both of these systems are based on a theory about how the economy should be organized. In reality, most economies are a mixture of both.

The United States has a free-market system – mostly. Almost all decisions are made by the free choices of producers and consumers. Still, there are parts of the U.S. economy that are planned. The government sometimes issues commands that limit the freedom of producers and consumers. These commands serve economic goals other than freedom and efficiency.

For example, minimum wage laws limit the freedom of producers by telling them the lowest wage they can pay their workers. The goal of a minimum wage is to promote economic security and equity by protecting workers from exploitation. Not everyone agrees that a minimum wage accomplishes this goal, and the value of minimum wage laws is frequently debated.

To many people, the free-market system is an important part of what the American flag represents.

It is in the Mix

When you mix two things, you can often get the best of both.

Freedom matters in the United States, but it is not the only thing that counts. Efficiency is important too, as are equity, security, and growth. This is why the U.S. government issues some commands, which means that the United States has a mixed economy. A mixed economy uses both free-market and command principles.

In freedom-oriented societies such as the United States, the commands are the exception rather than the rule – but the exceptions are usually quite important. The government limits freedom to serve other economic goals in areas that matter most.

The minimum wage has the goal of promoting security and equity by not allowing employers to exploit their workers. Experts disagree on its effectiveness.

Retirement is another important feature of a mixed economy. Social Security is a government program designed to ensure that retired workers age 66 or older receive a continuing income after retirement. Social Security was not intended to be a person's only retirement income and the system faces difficulties.

People are free to, and should, save for retirement in other ways in the private sector to ensure a better quality of retired life.

Stay in School

One familiar example of government command in the United States is the public-school system. This system provides a useful service: education. This service is so important for all people that the government does not leave it up to producers to organize. The states provide this service themselves. While producers may provide education through a variety of private schools, government guarantees free education to all. In fact, all parents have to provide their children with either public or private education up to at least age 16.

This is an example of the operation of a command economy within the United States. But free-market principles also operate. Even though the government guarantees that an education will be provided to all, a system of private schools exists to give parents a choice of where to send their children. This is not true in a pure command economy. There were no private schools in the Soviet Union.

Take Advantage

Free-market systems and command economies both have advantages and disadvantages. The free-market system serves the goals of freedom and efficiency very well.

Command economies do a better job of providing security and equity. There are ups and downs to both systems, and no one would try to argue that either system is perfect. But is one a clear favorite over the other?

The Pros and Cons of the Two Systems

Free-market systems usually provide a much greater variety of goods and services. Competition among producers leads to innovation as the producers try to figure out what consumers need and want. This innovation inspires a diversity of goods and services that is not likely to exist in a command economy. Planners do not have much incentive to innovate. On the other hand, a command economy can make sure that everyone has their basic needs met. Planners can direct the production and distribution of goods and services such as food, medical care, and education to guarantee that everyone gets these important things.

Inequality of wealth is one of the disadvantages of the free-market system. When people are given the freedom to make different choices, they each get a different outcome. Inequality is bound to result when wealth is distributed by free choices instead of an overall plan. This can lead to insecurity, too. A command economy can provide greater equality and security but at the cost of efficiency. Planners may be able to implement an overall plan that assures that basic needs are met, and wealth is distributed more equally, but the planning required uses up a lot of resources. When market forces do the work, resources are not wasted paying, housing, and feeding government planners.

What is Big Brother Doing?

There are important differences between a free-market system and a command economy. In capitalist societies, the government does very little to interfere with the economy. Market forces, or the «invisible hand» is expected to allow the economy to function properly.

In a planned economy, the government takes on the job of the market forces. This uses up a lot of resources.

There are advantages and disadvantages to both approaches. That is probably why most countries have a mixed economy, so they can get some of the advantages of each system and pursue several economic goals at once.

Life is full of decisions. So is the game of economics.

Players decide on economic goals. They decide on the rules of the game. They make allocation and production decisions. They decide what to exchange and for how much to exchange it.

Making decisions never really ends in the game of economics. In fact, the economy is primarily just a constant stream of decisions and their outcomes.

So how are economic decisions made? Let us take a look.

Yogi Berra, one of the greatest baseball players ever, once said about the game, «It ain't over til it is over.» This is not just true in the game of baseball. It is also true in the game of economics. No economic decision is over until it is over. In other words, you are not done with the decision-making process until you have carried out your decision. Even when you have already decided on a plan, you still have to decide whether to stick to it.

Life is all about personal choices. Sometimes decisions are easy; at other times they are difficult and require a lot of thought and maybe even sacrifice. Sometimes our decisions affect other people. This is true in baseball as well as in economics.

Weighing Pros and Cons

Compare going to see a movie with a trip to the dentist. Which sounds better: relaxing with a bucket of popcorn and a soda, or having someone poke around in your mouth with a metal instrument? If you are like most people, you would probably rather go to a movie than visit the dentist.

Think about it, however. There are pros, or positive aspects, to going to the dentist. And there are cons, or negative features, of going to the movies. Not even this decision is completely one-sided.

Cost-Benefit Analysis

Making decisions requires weighing the pros and cons. Good decisions can only be made after considering the different choices and picking the one that looks best. That is what players in the game of economics do.

Economists call this cost-benefit analysis. When you do a cost-benefit analysis, you look for the decision that has the maximum benefit with the minimum cost. In other words, the choice with the most pros and the fewest cons is usually the best option.

Be Rational

There is no rule that says you have to use cost-benefit analysis, but players who want to maximize benefits and minimize costs use it all the time. It is one of the properties of the game of economics.

You do not always have to list the pros and cons to do cost-benefit analyses. In fact, such an analysis happens frequently, and almost automatically. Any time you accept a cost, you are looking for a benefit. You have probably done a cost-benefit analysis of your own, even if you did not sit down to make a list of pros and cons.

Money Is not Everything

Money is one common way of calculating cost. You see price tags all over the place. It is normal to think of cost and price as the same thing, but the cost of a decision cannot be measured in money alone.

When you buy something with money, there are always additional costs. For instance, the time and effort involved in shopping are costs. And whatever you must give up by buying one thing instead of another is also a cost.

Imagine that you received $200 in birthday money. That is quite a benefit, but spending it involves costs. Maybe you decide to buy a new game console with the money. The price of the console is only one factor. There are hidden costs, too, such as gas for the car or bus fare to get to the store. The time you spend is another cost. So, while it may seem that you are getting something for free – a console bought with someone else's money – buying it brings certain costs. And maybe you wanted a new backpack and a pair of shoes, too. You are sacrificing those purchases for the game console.

That is Your Opinion

Cost goes beyond money. No price tag reveals the full cost of something. Everyone's feelings about cost are very personal. The way you calculate the cost of a decision depends very much on your tastes and your situation.

Whenever you buy something, there is a cost in time and effort beyond the price of the purchase. The time and effort spent on a task may be a high cost for one person and a low cost for another. An hour spent shopping probably seems like a low cost for someone who loves to shop – it may even seem like a benefit. But an hour spent shopping may be a very high cost for someone who does not like to shop. Time and effort are non-monetary costs of shopping.

Even monetary costs can vary depending on a person's situation. If you are a millionaire, paying $10 for a movie is not a big deal. If your job pays $7 an hour, however, that $10 may seem like a lot of money.

Everyone calculates costs and benefits differently. That makes these calculations subjective. In other words, they depend on a lot of factors that vary from one person to another. Because people's opinions and tastes differ, it affects how they see the costs and benefits of decisions.

Something's Missing

Unfortunately, not all rational decisions work out the way you might hope. Sometimes you ignore a cost, or overestimate the benefits. This does not mean you are irrational. You simply could not think of everything.

Often, it is impossible to predict what is going to happen. Unexpected costs arise. Benefits turn out to be less than you thought. That is normal, because no one can predict the future. That does not mean a cost-benefit analysis is useless, though.

Economic Reasoning

Cost-benefit analysis is sometimes called economic reasoning. In many ways, economic reasoning is just like any other kind of reasoning – it is a matter of weighing pros and cons.

Some might call this logic, others common sense. Whether you call it economic reasoning, logic, or common sense, it is all the same thing. It is how people play the game of economics. They make rational decisions hoping for benefits that outweigh costs.

There is no such thing as a free lunch, even when someone else is buying.

The economy is not just a collection of people. It is like a game, except that instead of playing on a board or a field, the players move within the greater economic system. They follow rules and make decisions, and these decisions result in outcomes.

Definition of the Economy

The economy is the total of all the outcomes that result from people participating in the economic system.

Economists measure and discuss the strength and performance of the economy. When they use words such as health, vitality, and even stamina, it sounds much like a doctor talking about a patient. This is not far from the truth.

Economic Indicators

Economists measure the health of the economy by comparing and analyzing economic outcomes that result from various activities. Economists use these instruments to measure economic activity. These instruments, called economic indicators, include

- Gross domestic product.
- Growth rates.
- Unemployment rates.
- Inflation rates.

Doctors use measurements to judge the condition of their patients. Economists measure the health of the economy.

Gross Domestic Product

Some indicators are used quite often to measure the health and vitality of the economy. For example, gross domestic product (GDP) is a very helpful, and widely used, tool.

The GDP measures the overall size of a country's economy. It is the monetary value of all goods and services produced in a country during a given time, usually one year. The GDP provides a good overall picture of how much economic activity there is within a country.

Understanding GDP

Gross domestic product is the sum total of private consumption, government spending, investment, and the net value of exports. The net value of exports, sometimes called the trade balance, is the value of the goods exported minus the goods imported.

The equation can be put more concisely as follows:

GDP = private consumption + government spending + investment + exports – imports

A common mathematical formula for measuring GDP looks like this:

$GDP = C + G + I + Ex - Im$

Private consumption includes all the goods and service purchased or consumed by individuals. Government spending includes all the costs incurred by the government, such as salaries of government employees, military spending, funding for education, and so on. Investment is limited to business investments in capital, and it does not include financial investments such as savings accounts or bonds. Exports are those goods that are produced inside one country and sold in another country. Imports are the reverse – goods made outside the country and purchased within the country. Imports are subtracted from the GDP because they are purchased from other countries before they are sold within the United States. These funds contribute to another country's GDP.

The GDP is a very weighty number for every country in the world.

World GDP

GDP is an important economic indicator. The bigger the GDP, the more activity there is in a country's economy. For large countries, the GDP numbers are likewise usually very large. Sometimes a country's GDP is so large that it is hard to comprehend. So what does a GDP number really tell us?

There are a couple of ways to make the GDP more meaningful. One is to make comparisons. For example, in 2011, the GDP for the entire world was just under $70 trillion. The same year, the GDP of the United States was about $15 trillion. That means that roughly one-fifth of all economic activity in the world took place in the United States. That is a lot of economic activity for one country.

The United States has the largest GDP in the world, as evidenced by our many shopping malls.

Annual GDP

You can also compare the GDP from one year to the next, which gives an indication of economic growth on an annual basis, or year by year. For instance, if a country's GDP grows by 10 percent from one year to the next, the economy is growing rapidly. If its GDP goes down, the economy is weakening. If the GDP stays about the same, the economy is stagnating.

Another way of making the GDP useful is to look at per capita GDP. To do this, you divide a country's GDP by its population. This tells you the average amount of economic activity contributed by each person in that country.

Growing Up

There are measurements for almost every type of economic activity. These measurements are usually reported as growth rates. Growth rates show how much economic activity there is in specific parts of the economy.

There are additional indicators that show how fast the economy is growing (or shrinking) in particular areas. There are also dozens of other government statistics that measure economic activity, all of which tell us how well businesses and consumers are doing.

Additional growth indicators include

- Corporate profits.
- Farm income.
- Industrial production.
- New housing construction.
- Personal income.
- Retail sales.

Growth is important for an economy.

Help Wanted

GDP and other growth indicators measure the amount of activity taking place in an economy. Another way to measure activity is to look at inactivity.

One important measure of inactivity is the unemployment rate. This indicator tells us the percentage of workers who are out of work. This is a good way to measure the health of an economy. When only 5 percent of people are out of work, the economy is much healthier than when the unemployment rate is 10 percent.

As with GDP, comparisons across time provide a more useful perspective. If the unemployment rate is declining, that means more people are working. The economy is getting stronger. If the unemployment rate is rising, then the opposite is true.

Did You Know?

A country's unemployment rate might actually be higher than what is officially listed. This is because many people who are out of work do not report this fact to the government, so they do not get recorded as part of the total percentage of unemployed citizens.

When a lot of people are out of work, the economy is not healthy.

The Rising Cost of Living

People from an older generation remember when a penny or a nickel was worth much more than today. There is a reason your grandparents could buy candy for a penny, while you have to spend close to a dollar. It is called inflation.

Inflation is a feature of economic systems that demonstrates that as time passes, things get more expensive. This might seem unfair if incomes always stayed the same. But usually incomes go up as prices rise. This helps offset increases in the cost of living.

Still, not every good or service increases in price over time. In fact, some prices actually decrease over the years. When a technology is very new, it is often quite expensive. As technology advances and new ways are discovered to produce something more efficiently, the price of an item might actually decrease. Examples of items that have decreased in price after first being introduced are radios, televisions, and personal computers.

The average price for a gallon of gas rose during a relatively short period of time. Think about possible reasons why the price continues to rise today.

The Increasing Price of Gas

1977: $0.55

1980: $1.00

1990: $1.25

2000: $1.55

2006: $3.00

2014: $3.56

The Inflation Rate

The U.S. government measures inflation with something called the Consumer Price Index, or CPI. The CPI is the average price of a group of goods and services such as food, transportation, and medical care. As the CPI rises, economists can get an overall picture of how fast prices are rising. This lets them determine what the inflation rate is.

The inflation rate is an important economic indicator. It lets people know how fast they should expect prices to rise.

The inflation rate can also be used to adjust for the effects of inflation. Doing this shows how much something in the past would cost today. For example, by calculating the inflation-adjusted price, you would find out that something you paid $5 for in 1990 would cost $8.90 in 2013.

It is easy to see the effect of inflation – did you ever see gas selling so cheaply?

What Your Money Can Buy

Prices are always going up, but not all prices rise at the same rate. Some prices go up faster than the inflation rate, while others go up more slowly.

If the actual price and the inflation-adjusted price are about the same, then the price has not really gone up, even though the number on the price tag is bigger.

For example, when gas went from 55 cents per gallon in 1977 to $1.55 in 2000, that was about equal to the inflation rate. So, gas cost about the same. But inflation would have made that $1.55 in 2000 into only $1.82 by 2006. When gas went up to $3, it rose faster than inflation.

Often, when prices go up faster than the inflation rate, it is a result of high demand. For instance, football is a more popular sport today than it was in 1975. So prices for tickets to the Super Bowl have increased more than three times as fast as the inflation rate. Other areas where prices have outpaced inflation include medical care and college education.

If prices rise at 4% and your income does the same, you are not harmed in the short run. But you might be harmed in the long run as you try to save for college or retirement if your savings cannot keep up with rising costs over a long period of time.

As time goes by, a dollar buys less and less.

Knowledge Is Power

Decision making is an important part of the game of economics. Making good decisions requires knowledge, skill, and information.

The indicators give economists and others a fairly good picture of how the economy is doing.

Economic indicators have an influence on the decision-making process. For instance, the inflation rate is useful for making smart decisions. Imagine that you want to buy an expensive new TV. If the inflation rate is high, it might make sense to buy the TV now before it gets much more expensive. On the other hand, it might make more sense to save the money because your rent and food bills are going to go up, too. Economic indicators are like signposts guiding you along an economic path. If read correctly, they can help an economic player arrive at safely at a destination.

People who try to make money in the stock market use all kinds of information to make predictions.

Doctoring the Economy

Economists are like doctors who try to determine the health of the economy. They use different measures, such as gross domestic product, growth rates, the unemployment rate, and the inflation rate. These indicators provide useful information when it comes to making good decisions.

Unfortunately, unlike doctors, economists cannot cure economic sickness. They can diagnose the problems, but they leave it to us to make our own economic choices.

Economists examine the health of the economy.

Someone born in 1950 lived without computers for some 30 years, and then witnessed the evolution of laptops and the Internet. Later, he or she witnessed the invention of the cell phone and then the development of smart phones.

All this technology has drastically changed the way people live. Changes in technology affect the economy on a large scale, which in turn affects how people play the game of economics.

What could be coming next? We do not know exactly, but we do know there is something coming. And it will probably be amazing.

Humans are always striving to do things better. Developing technology is one way to do this. The advancement of technology leads to greater speed, higher production, and increased efficiency.

Many people think of technology as electronic devices such as computers, cell phones, and other wireless tools. These kinds of devices can certainly improve results in many areas.

Computers help people work faster by making it easier to find, organize and reorganize information. Cell phones make it easier to get in touch with others. Some devices can include a calendar, address book, computer, camera, and phone all in one.

But technology includes more than just smaller, faster, more powerful electronic devices. Technology is any new advancement in or application of science that improves results.

The Power of Machines

For thousands of years, humans have been inventing things to make their work easier, faster, and more efficient. Many of the things people have invented are machines that use power to replace human or animal effort.

You can get from one place to another in a horse-drawn carriage. But the car, once known as the «horseless carriage,» gets you there much faster. The car improves the ride.

The horse-drawn carriage was a technological development a long time ago. It provided an alternative to walking for those who could afford it. With a horse-drawn carriage, people could get to places much faster and with less effort.

The car increased that speed and reduced that effort even more.

Build a Better Mousetrap

New technologies are invented every day. In most cases, today's devices are not made to replace human or animal effort. Instead, they are designed to replace older, less powerful machines with newer versions.

For example, the telephone replaced the telegram. While the telegram was the fastest way of getting messages from one place to another in its time, the telephone further increased the speed of communications.

More recently, cell phones are quickly replacing home phones and other so-called «land lines.» Home phones make calls fine, but their area of use is limited. Cell phones can go anywhere. This development makes an already powerful technology even more effective.

A Method to Their Madness

There is more to technology than just machines. Smaller, faster, more powerful machines lead to improved results. Better results can also be produced by organizing time or energy in new and different ways. Technological improvement can come from introducing a new method.

Methods are all over the place, even if you do not realize it. Nearly everything you do follows a method of some sort. How many fingers do you use to type, two or 10? That is your method. Do you brush your teeth with a side-to-side or swirling motion? Whichever you use is your method.

Some methods can be improved by changing them. These improvements are also technological developments. They improve results and make people's lives better by increasing speed, efficiency, power, and so on.

Productivity Is Up

Producers like to improve efficiency. If they can make goods more easily, more quickly, and with less money, they can increase their profits. Producers are always looking for technological improvements to increase productivity. Machines can help do this.

Power tools tighten bolts more quickly than regular wrenches. Electric sewing machines enable faster production of clothing than a needle and thread. Backhoes haul much larger loads of dirt than shovels.

These are just a few examples. Machines are used in almost all types of production to make things easier and faster for workers. Sometimes, machines even replace workers entirely, eliminating human effort from the production process.

New methods can also increase productivity. One of the most powerful production methods is the assembly line.

The assembly line is a simple concept. Instead of having workers move from one production task to another, workers line up and each performs just one task as the product moves down the line. Each worker performs a different task very quickly as products move along. Also, each task uses just one tool, so no one has to put tools down or move to a different position. This eliminates extra extra motion and increases the speed of production.

The assembly-line method can be used to do anything that requires several steps, which is just about everything.

Prices Are Down

Improving productivity has major effects on the overall economy. For one thing, increased productivity usually leads to lower prices.

According to the law of supply and demand, when supply increases, prices drop. When technology makes production more efficient, there is usually more supply. That brings down the price of those goods. When the price of a good drops, more people can afford to buy the good, so producers make more sales and more profits.

The increased demand because of lower prices would normally raise prices again. But greater productivity helps producers meet rising demand with even more supply, so they can keep prices low.

Greater productivity brings cheaper goods to more people and wealth to the producer. Producers use some of this wealth to develop even better technologies, further increasing productivity.

Increased productivity makes more goods available more cheaply.

The Ripple Effect

Technology increases productivity by making it easier and cheaper to produce goods and services. This lowers prices and brings more goods and services to more people. There is also a ripple effect that occurs when goods and services are widely available. When more people have access to something, it changes how they behave.

Think of the cell phone. When very few people had a cell phone, its usefulness was limited. You could usually only reach people at home because few other people had cell phones.

However, as cell phones became less expensive, more and more people could buy them. Eventually, cell phone owners could reach more people in more places. That increased the number of calls. Today, most people can be reached no matter where they are.

Prices came down, more people got cell phones, and the number of conversations went up. That is the ripple effect in action.

Although Ransom E. Olds of Oldsmobile invented the original assembly line, Henry Ford introduced conveyor belts to the design, which greatly sped up production.

By 1914, the Ford factory was turning out a new Model-T every 93 minutes. Because of the speed of production, the Model-T could be made and sold very cheaply. Cars were no longer a luxury. Suddenly, millions of people could afford cars, and it did not take long for most families to have a car.

This had a ripple effect on the way people lived. Now that cars were so common, people could live farther from where they worked. This led to the development of suburbs. Instead of living in crowded cities or distant farms, people had both space and access to the city.

Ford's assembly line changed the place – and the way – many people lived.

Because of the development of suburbs, more highways were needed for people to get back and forth to work. Soon there were highways connecting different cities all across the country. These highways made it easier to go long distances, and that meant that people could take vacations to far away places by driving there.

The tourism industry became much larger once most Americans had cars. With increases in tourism came more motels and amusement parks and restaurants.

The Model-T changed America into a car society, and this affected other parts of the American economy. Increases in productivity often have this kind of ripple effect.

Make It Fast

Distribution is another area that benefits from technological improvements. If productivity is improved, prices go down and more goods are available to consumers. And if goods can be moved around more quickly and inexpensively, the same thing happens.

Technology has been helping improve the distribution of goods since the first horse-drawn cart was piled full of goods to be transported elsewhere. In the past 50 years, there have been drastic improvements in distribution technology.

FedEx changed the package delivery industry by introducing a new type of system called the hub-and-spoke model.

Strange as it may sound, FedEx sent all of its packages to a central facility in Memphis before shipping them to their final destination. Even if you were sending a package from New York to Boston, it went to Memphis first. This is called the hub-and-spoke-model of distribution.

Here's how Fred Smith, the founder of FedEx, explained the advantage of this method:

If you take any individual transaction, that kind of system seems absurd – it means making at least one extra stop. But if you look at the network as a whole, it is an efficient way to create an enormous number of connections. If, for instance, you want to connect 100 markets with one another and if you do it all with direct point-to-point deliveries, it will take 100 times 99—or 9,900—direct deliveries. But if you go through a single clearing system, it will take at most 100 deliveries. So you are looking at a system that is about 100 times more efficient.

FedEx not only used this new method of shipping packages. They employed new technological devices to make sorting and delivery easier. FedEx used bar codes to sort and track packages, and it put computers in delivery vans to map the driver's route and continue tracking packages.

Both the hub-and-spoke model and electronic devices led to faster deliveries. Soon other delivery companies were imitating Federal Express. Today, fast, and reliable delivery is a regular part of life, thanks to FedEx and the technological advancements they developed and used.

Simplicity

Technologies do not have to be complicated or powerful to have a major impact on productivity and distribution. Sometimes it is enough just to make things simpler, like FedEx did, or to standardize methods.

One of the most influential technological advancements in the past century did both of these things. The cargo container is just a simple rectangular box, but it changed the world of shipping and distribution by standardizing and simplifying.

The cargo container is partly responsible for rapid increases in global trade.

The Revolutionary Box

Cargo containers are simple metal boxes with a wooden floor, 8 1/2 ft high and either 20 or 40 ft long. Because of their simplicity, the cargo container has increased the efficiency of cargo transportation, making the distribution of goods both faster and less expensive. This has increased the amount of international trade and made it possible for consumers to purchase goods more cheaply. There are nearly 15 million of these boxes currently roaming the Earth, and in 2005, nearly 8 million containers entered the United States. Their cargo was worth almost $800 billion.

Before containers, cargo was loaded and unloaded by dockworkers known as longshoremen. Longshoremen could sometimes use cranes and forklifts, but much of the cargo was contained in bags, boxes, and barrels that had to be moved piece by piece, sometimes by hand. This took a very long time and was tiring and dangerous. A normal ship could take a week or more to unload, with 20 longshoremen working around the clock. The cost of paying these dockworkers was enormous. Labor costs were at least half of the total cost of shipping goods.

With the use of cargo containers, freight can be loaded and unloaded much more quickly and easily. Special cranes called straddle carriers pick up and drop off containers. The straddle carriers grab containers, wheel them from ship to dock or vice versa, and drop them again, transporting a large amount of cargo in a matter of minutes. It now takes less than 10 hours to unload the same amount of cargo it once took a week to unload, and the process requires fewer workers and is less likely to involve accidents or breakage.

The cargo container also makes it much easier to transport goods from the dock to warehouses, distribution centers, and stores. The containers can be put onto flatbed train cars just as easily as they are loaded and unloaded from ships. Or they can be placed on wheels for transport by truck. Goods can go nearly the entire length of their journey from factory to store in the same container. This eliminates all of the wasted time of loading and unloading freight into different carriers.

The increase in speed and reduction in labor costs have made distribution much less expensive, and this makes the prices that consumers pay much lower. Before the cargo container, shipping costs accounted for about one-eighth of the price of goods. The cut that goes to shipping is now less than 1 percent. For example, it costs only 34 cents to ship a pair of shoes from an Asian factory to an American store that can sell the shoes for $45. The shipping costs once would have been $6 or $7. With such high shipping costs, it made more sense to simply make the shoes in America, where they were going to be sold. But many goods can be made more cheaply in other countries, and now that it is inexpensive to ship them to America, they cost much less at the store. This simple technology – the rectangular box – has revolutionized shipping and helped transform the global economy and the American consumer experience.

The Economic Effects of Technology

There is so much technology available today.

Technology can improve production and distribution. The improvements affect the price and availability of goods and services. They also influence how people live their lives.

Technology gives us different options and affects our decisions. When we are looking at the overall economy, we cannot ignore the effects of technology.

Think of all the things you do on the Internet, whether you use a desktop computer, a laptop, a tablet, or a handheld device. You can stay in touch with friends, catch up on the news, watch your favorite shows, or just check the weather forecast.

But the Internet is not just about getting information or having fun with friends. The Internet is also a key technology that has affected the overall economy. In fact, the Internet is the world's largest marketplace.

The Communication Explosion

Different technologies have made it easier and easier to communicate. The invention of the printing press made it easier to print a large number of books. The invention of the radio made it possible to broadcast stories to large audiences.

With the Internet and smart phones, information of all kinds can be shared very efficiently with nearly everyone on Earth. We can send and receive documents, pictures, videos, and audio files over the Internet and over our phones, and we can do it almost instantly.

The ease of sharing information has led to a huge increase in the amount of communication taking place. People are sharing information far more than they ever have. Think about all the e-mails you write, and the texts you send. Would you ever write that many letters?

The Internet does more than increase communication. It affects how people live their lives. Information is necessary for making decisions, so the Internet impacts how people make choices.

Easier, faster communication gives both producers and consumers access to a greater amount of information. People can learn more to help them make better decisions, and they can make these decisions more quickly. Producers can communicate almost instantly with their employees, their suppliers, and everyone else involved in making allocation decisions. Meanwhile, consumers have the latest information about prices, availability, and quality, enabling them to make the wisest buying decisions.

The amount and speed of information sharing can help improve the way people play the game of economics.

It is easy to communicate these days, even on the go.

E-Commerce

Access to information is not the only way the Internet has affected the economy. The Internet has created an entirely new type of economic activity called e-commerce. It refers to online buying and selling of goods and services. E-commerce is the electronic form of retail sales.

E-commerce has changed the way many companies do business. Almost every store has a website that sells items people previously had to buy in their stores. Many companies do not have actual stores at all; they only sell online.

One of the earliest pioneers of e-commerce was Amazon.com, and the company remains one of the largest online retailers. Amazon began by selling books on the Internet. After achieving rapid success, the company branched out into other retail areas. Amazon now sells products ranging from electronics and toys to clothing, jewelry, tools, and more. Amazon is a leader in e-commerce, and its business practices have influenced the entire retail industry.

E-commerce allows just about anyone to become a global seller of goods, services, and information online. Online business gives producers access to the largest market available, with over 1.5 billion people who go online on a daily basis.

The Internet is getting more popular among shoppers.

The Growth of E-Commerce

E-commerce started taking off in the late 1990s. Since 1999, buying and selling online has been the fastest-growing activity in the U.S. economy.

Both consumers and producers have gone online to buy and sell, and this trend does not seem to be stopping. The amount of money spent online has been growing very quickly. In 1999, there was $15 billion worth of online sales. The next year, that total had almost doubled to $29 billion. Ten years later, U.S. retail e-commerce sales had reached $169 billion in 2010. In fact, from 2002 to 2010 retail e-sales increased at an average annual growth rate of almost 18 percent, compared with 2.6 percent for total retail sales. In 2014, e-sales were about 5.9% of total retail sales.

The growth in e-commerce has been remarkably fast, but even with the fast growth of e-commerce, online sales represent less than 6 percent of all retail sales in the United States. This means that 94 percent of all goods sold are still purchased the old-fashioned way: in a store.

The Advantages of E-Commerce

Why is e-commerce becoming more and more popular? Using the Internet to buy and sell has advantages for both consumers and producers. That is why online shopping is growing so quickly.

The Internet makes it easy to compare prices. With traditional shopping, it takes multiple trips to different stores to compare their prices. There are Web pages that allow you to see how much dozens of different stores charge for a particular product. Or you can just click from one company's website to another without having to go anywhere.

Online shopping saves time and money. You do not have to go anywhere to buy online. You do not have to spend time looking for parking, walking into and out of the store, or buying the gas to get you there.

Online shopping lets you get things not normally available nearby. With the Internet, the entire world is your store. Wherever something is made or sold, it can be shipped directly to you or anyone else.

You can ship gifts without an extra trip to the post office. You can do your gift shopping at the last minute and have the box sent right to the recipient. Most online stores give you the option of including a card and gift wrap.

Consumers like online shopping because of the convenience and availability. E-commerce has advantages for producers too. The Internet makes selling goods and services more efficient for many businesses by eliminating unnecessary costs.

Online businesses do not need as many employees. Instead of a bunch of salespeople and managers, online businesses only need to hire people to load goods onto trucks for shipping to their customers.

With e-commerce, there are fewer stores to run. Some businesses do not even have real stores at all, just warehouses. This saves on rent and labor.

The Internet is an easy form of direct advertising. Instead of putting ads in newspapers and magazines, and on television and the radio, a company's website is an ad that consumers can look at any time. Advertising on other websites is also less expensive and reaches millions of viewers.

What Sells on the Internet?

E-commerce has done a lot for the computer industry. The sale of computers has grown a lot since the Internet began taking off. In 1990, few people had computers in their homes. By the year 2011, over 75% of all-American households had at least one computer.

People with computers are naturally drawn to e-commerce for computer products. It is easy to buy printers, scanners, wireless routers, and more from online sellers.

What else do you think sells well online? Popular online purchases, with the percentage of total online sales, include

- Computer products: 40%
- Books: 20%
- Travel: 16%

- Clothing: 10%
- Music: 6%
- Gifts: 4%
- Stocks: 4%
- The Internet and Economics

Developments in technology have always influenced the overall economy. Through the Internet, people have access to more information, which affects their decision-making process. And e-commerce is a fast-growing type of economic activity.

Whatever other technological changes are coming, it is likely that the Internet will continue to have a growing effect on the game of economics.

CHAPTER 1 SUMMARY

The Game of Economics

– Economics is a game played by everyone, in which every player has roles and goals.

– Like other games, the game of economics has rules, properties, and outcomes.

– Unlike other games, economics has no winner. This is mostly because there is no rule that says when the game has to end; in fact, the game of economics never ends.

– Economics is all about the allocation of resources for the production and distribution of goods and services.

– Efficiency, equity, freedom, growth, and security are all goals different players have in the game of economics.

– Although goals are sometimes incompatible with one another, they still must be set in order to play the game of economics.

– Scarcity occurs because resources are limited. This is one reason why allocation decisions are so important.

– The fundamental questions faced by all economic systems are: What will be produced? How should production be organized? How will goods and services be distributed? What is the most effective allocation of resources?

Chapter 2

You live in a world where goods and services are essential. Can you imagine what the world would be like if you could not buy food, use public transportation, or attend classes? The goods and services you use every day are important. Your life would not be the same without them.

In the game of economics, different players produce and consume these goods and services. Consumers and producers make the decisions that drive the game of economics. They gather information and weigh options before making a choice. They ask themselves certain questions: How much am I willing to spend? Or how much should I produce?

The way people answer these and other important questions determines how they allocate resources. And this in turn affects the production, distribution and consumption of goods and services. Economics is powered by the many decisions made by players. Examine how the various players go about making these important decisions.

Economics is like a game. It has rules, properties, outcomes, and players. We all play the game of economics, and of course players are an important part of any game. They make the decisions that drive the action. Economic players make decisions about what to produce, sell, and buy.

Any time you buy something, you are playing the game of economics. You are participating in the economic system. To understand the importance of your role as a player in the economy, as well as the roles that other people play, examine what the many different players do.

People also have wants – that is, things they desire but could live without, such as concert tickets or the latest basketball shoes. Everyone has needs and wants, and everyone tries to fulfill both, if possible.

Everyone plays the game of economics all the time. Even the simplest actions are economic actions. For instance, if you download a ringtone to your phone, you are playing the role of a consumer. Your cell phone is a good.

Consumers make purchases depending on what they need and want. But of course, they must also consider how much money they have to spend, and the prices of the things they want. The decisions made by consumers send messages. The ring tone is a service. Your cell phone provider plays the role of producer.

In every type of economic system, there are exchanges between consumers and producers. The decisions that consumers make influence the decisions of producers. Producers decide what and how much to produce, depending on the desires of consumers.

Consumers

to the other group of players, the producers. Consumers let the producers know what they want to buy and the price they are willing to pay. Every time a consumer decides, it sends this kind of message.

Price has a major effect on a consumer’s decision to buy. If the price of a movie ticket is too high, you might stay home and watch a DVD instead. On the other hand, if the movie theater slashes prices, there will be long lines at ticket office of consumers waiting to see the latest release.

The important role that consumers play includes deciding

– What products and services to use and buy.

– How much to buy.

– What price they are willing to pay.

Producers

Consumers make purchasing decisions, but there would not be anything to purchase without producers. Producers try to satisfy the needs and wants of consumers. They provide consumers with such goods and services as clothing, food, entertainment, and healthcare.

To be successful, producers have to determine what consumers want and how much they are willing to pay. Producers make all their decisions based upon the decisions made by consumers. So, producers are always trying to predict what consumers will want next, and how much they will pay for it.

Have you ever been to a water park? How many services do you buy for the price of admission? You can go down a variety of slides, swim in a wave pool, or maybe even watch a live show. At a water park, producers offer many goods and services in one place. To make a profit, they must be able to anticipate how many consumers will want to buy their many goods and services, and what they will be willing to pay.

Producers play an important economic role. They decide what to produce, how to produce it, and for whom it will be produced. If they make the right decisions, they will satisfy consumers' needs and wants.

Workers as Economic Players

Producers produce the things that consumers buy. These things have to be made. The people who make the goods and provide the services sold by producers play an important role in the game of economics. We call these players workers.

Workers create goods and services.

Workers, however, are not a third group of economic players. When they make or provide goods and services, they act as producers. But when they purchase things, they act as consumers. Workers play a dual role. They are producers and consumers.

Workers as Consumers and Producers

Workers straddle the line between consumer and producer. Sometimes these two roles can be played simultaneously. For example, when a restaurant employee is sent out to buy potatoes, that worker is both a producer (someone making food) and a consumer (someone buying food).

Open Workers as Consumers and Producers. Sort the activities into the correct column to show when a worker is playing the role of a consumer, a producer, or both.

Businesses as Economic Players

When they make goods or provide services, workers play the role of producer. But it takes more than workers to offer those goods and services to consumers. For instance, a restaurant is more than just a group of workers who decide to make and serve food to people. A successful restaurant needs someone to apply for the appropriate permits, rent the building, hire employees, buy equipment, and oversee production.

When a person or a group of partners decides to undertake these tasks, they start a business. Businesses provide the goods and services the consumers want by hiring, organizing, and supplying workers. Nothing would get made without workers. But it is the task of businesses to get those things to the consumers who want them.

Business Activity

Businesses drive most economic activity. Without businesses, workers would not have anything to produce, and they would be unable to earn money. Without money, they could not play their other economic role as consumers.

When a new business opens, jobs are created for workers. Businesses are producers. But they also provide what the economy needs for consumption. They pay workers what they need to consume the goods and services offered by producers.

For example, when Dell Inc., a computer company, opened a factory in Austin, Texas, in the 1990s, the company provided thousands of jobs for workers in the area. The new workers then had money they could spend on goods and services. This boosted local businesses and created even more jobs in the area. In turn, this led to workers earning more money to spend on things such as Dell computers. From this example, can you see how a big business might help to circulate money within a community?

Government as an Economic Player

So far, you have seen that most economic decisions in the United States are made by individual consumers or businesses. But even under the American free-market system, the government of the United States still plays an important role in the economy. The U.S. government tries to maintain steady growth, keep prices stable, and provide public goods and services. An example of government action came in 2006, when the U.S. government helped stabilize the price of oil by ensuring that oil companies could not raise the price of gasoline above a certain limit. This enabled consumers to continue to afford and use gasoline.

This decision also affected the government, because it also buys a lot of gas. The government plays the role of consumer even while it is attempting to guide and benefit the economy.

Send My Bill to the Government

In many countries, the government plays a more active role in the economy. In Canada, the government provides universal healthcare to all its citizens using taxes paid by workers and businesses. In this case, the government plays the role of producer.

How Does the Government Play?

The government can fill the role of consumer as well as producer. After all, it takes goods and services to run the government. It is helpful, therefore, to think of the government as a very large, public business.

View How Does the Government Play?, then sort the activities into the correct column to show whether the government is playing the role of consumer or producer.

Playing Roles

Consumers and producers play important roles in economics. They decide what to buy or what to produce, and how much of it to buy or to produce. Other players in this game include workers, businesses, and government.

In a free-market system, people are free to decide what to buy. But those choices can be influenced by others. Sometimes people are influenced by family, friends, or advertisements. People are also influenced by what is available, how much it costs, and how much money they have. There are many things that can influence the decisions of consumers.

Producers are also affected by many influences. What do consumers want? What will they pay for those things? What kinds of advertisements help them decide what to buy? These and other questions influence what producers make. Questions about resources influence producers, as well. They need to know what resources are available for production, how much they cost, and how far away they are.

Who Has the Power?

Deciding what to buy seems simple. You choose what you want and pay someone for it. But the buying and selling of goods and services is much more complicated than that. Part of the reason lies in the fact that producers make so many different products. For consumers it can sometimes feel overwhelming. With so much to choose from, it can be hard to decide.

Why do producers make so much stuff? Producers want to sell their goods and services, but not everybody wants to buy the same things. If they did, restaurants would have one-item menus and electronics stores would have only one kind of television.

Consumers have the power to decide what to buy. Producers are aware of this. They make products and services based on what they think consumers will buy. This means producers must pay close attention to how consumers behave. By understanding what consumers have done with their money in the past, producers try to predict what they will be willing to buy in the future. Because of this, consumers have a great influence over the actions of producers. Consumers have a great deal of power over producers.

The Power of Producers

Consumers may make the final choice about what to buy, but that does not mean producers have no power of their own. The choices made by consumers are always limited by what is available. Consumers may want to buy something, but unless a producer makes it, they are out of luck.

Producers determine what is available, and this gives them economic power. For instance, when the quantity of a popular product is limited, consumers will often pay a higher price. For a variety of reasons, including the popularity or rarity of an item, consumers might buy even though the price is high, the quality is not as good, or the choices are limited.

In this way, producers have a great influence on what is bought.

Guessing Game

To sell the things, the goods they make and the services they provide, producers want to know what consumers want. What makes them happy? Producers might make an original product that becomes incredibly popular and sell millions. Or they might make an original product that nobody wants and get stuck with a full warehouse and a lot of unpaid bills. Production sometimes feels like a guessing game.

Producers want to become masters at this guessing game, and they use a variety of methods to do so. Surveys or focus groups are used to test ideas on small groups of consumers. Based on their reactions to new products producers can make better guesses about what the general public will buy.

Collecting information on what consumers like and dislike is called market research. If producers can predict what consumers will buy, what products will be popular, or even simply what people need, they can produce a lot of it. That allows them to sell what they make and grow their business.

Cultural Influences

Producers and consumers influence each other. But the choices made by consumers and producers are also affected by other factors. Culture plays a significant role in economic decisions.

In most societies, the goods and services produced help distinguish one culture from another. Things like food, art, sports, clothing, and literature differ between cultures. Consumers are influenced by their own cultural values and traditions. These traditions influence consumers to buy certain kinds of goods and services. They also have an effect on what producers make.

Producers have to be very conscious of what consumers are going to buy, and many consumer decisions are influenced by cultural values. For instance, many cultures value sports. In the U.S., sports such as baseball, football, and basketball are valued very highly. In Europe and Latin America, soccer plays an important cultural role; in some countries, people are even allowed to take time off work to watch a big game or the World Cup. Sports fans all over the world spend millions of dollars every year on tickets and merchandise, but which sports are valued – and therefore potentially valuable to producers – depends on the culture.

Holidays are another important cultural feature. Thanksgiving is a big holiday in the U.S. People travel by air, car, and train to spend time with their families and eat a special meal. In countries such as Iraq, Lebanon, and Jordan, Eid is a very important holiday. Parents buy their children new clothes, shoes, and toys during Eid, which takes place during three days at the end of Ramadan. They also prepare and share special dishes and take time to visit with family and friends.

In Asian countries such as China, Korea, and Vietnam, the Lunar New Year is the most important holiday of the year. In China, for example, the festivities begin on the first full moon of the year and can last for up to 25 days. The New Year is a time of renewal. Families spend time together eating rich foods and paying respect to ancestors and elders.

Different holidays lead to different consumption decisions, and these consumption decisions affect producers. A producer in China is not going to be very successful trying to sell turkeys in November, but a producer in the U.S. would be wise to go into the turkey business around Thanksgiving.

Peer Pressure

Consumers do not always buy goods and services because of a need or a want. Sometimes consumers make purchases because they feel pressured. Sometimes people buy products simply because others are. This is known as peer pressure.

Peer pressure influences consumer behavior, and it does not just apply to young people. People of all ages feel peer pressure. For example, an adult might feel pressure to buy a luxury car, a boat, or some other expensive item simply because that is what other successful adults do.

Because peer pressure can convince consumers to buy things they might not otherwise purchase, producers like it. Producers cannot control peer pressure, but often try to start a trend in the hopes of creating peer pressure. Producers try to anticipate what the next trend will be, especially during a holiday season like Christmas. They can make a lot of money if they produce the right product at the right time.

Scarce Resources and the Environment

The decisions made by consumers and producers are also affected by the availability of resources. Today, many resources are becoming scarce at the same time that the needs and wants of consumers are increasing. Meeting those needs and wants is a big challenge for any society.

Goods and services can become scarce as a result of limited availability of natural resources. Environmental changes can also lead to scarcity. For example, farmers who experience drought or floods might lose their crops – an important resource. Big cities can lose electricity, another kind of resource, during heat waves.

A Game of Influences

In economics, the players all make free choices, but these free choices are not completely free from influence. Consumers and producers influence each other with the decisions they make. Culture, peer pressure, price, and environmental changes also affect these decisions.

View A Game of Influences, and match each economic situation listed in the left column with the type of influence it corresponds to in the right column.

Over the years, the quantity and variety of goods and services available to consumers has greatly increased. Consumers have many more choices today than ever before.

On one hand, this makes consumers' choices easier because they can usually find something that they want to buy. However, at the same time it also makes consumer decisions harder. With so many choices, consumers have to sift through many options to find the one that suits them. This takes time and energy.

Consumers use different decision-making methods based on personal values and outside influences. To understand how consumers, participate in economics, we need to understand how they make decisions and what factors influence these decisions.

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Like everyone else, you make decisions every day. But do your decisions always make sense? You certainly hope so. When it comes to buying, we all try to use rational choice before we make a decision.

When consumers make a purchase, they try to make rational, or wise, decisions. Often, economic decisions are made after thinking about price, quantity, need, and sacrifice. But sometimes economic decisions are irrational, or unwise. Irrational economic decisions can lead to trouble.

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Cost-Benefit Analysis

To make rational choices, we need lots of information. In fact, making wise decisions usually involves cost-benefit analysis. A rational choice will seek to maximize benefits while minimizing costs. Costs and benefits differ from one consumer to the next, so each person's rational choice will be different as well.

It is Your Call

Think, for example, of trying to make a wise decision about which cell provider to use. One company offers 5,000 minutes for $50. Another gives 2,000 minutes for $45. The extra benefit is 3,000 more minutes for a cost of only $5. It seems like a good deal, right? If you regularly use 3,000 minutes per month, it is a good deal. But what if you never use more than 1,500 minutes per month? There is no need to pay for extra minutes if you will never use them.

By using information about the two plans and your own needs, you would be able to make a cost-benefit analysis and come up with a rational decision.

Financial Planning

Cost-benefit analysis is helpful when it comes to making decisions, but it is not the only tool used by consumers. Consuming usually involves money, and most of us need to plan ahead and keep track of our money to make sure there is enough when we need it. This involves financial planning, which is the creation of a strategy to pay for necessities and save for future goals.

Give Me a Break

Imagine that you have saved some money and now you are ready to choose how to spend it. Some of your friends are planning to go to the beach on the weekend. You would like to join them, but if you spend your money on a day at the beach, you will not have any left. Do you need or want that money for something else? A financial plan can help you answer the second question.

As with rational choice, financial planning requires information and an understanding of your financial goals. Financial planning is another form of rational choice. You decide whether the benefits of a purchase now are worth the cost of not having the money for a different purchase later.

The Benefits of a Budget

One tool that some consumers use to help with financial planning is a budget. A budget allows a person to control how much money is coming in and how much is going out.

The main idea behind a budget is to have enough money to pay for the thing you want and need. A consumer with a budget knows whether he or she can afford to go on a beach vacation without spending money needed for rent or bills. A budget can also help consumers reach their financial goals. A budget can help you save for the future by keeping your expenses below your income. This leads to savings now for spending later.

Top Five Benefits of a Personal Budget

Know how much money you are making.

Know how much money you are spending.

Know how much money you are saving.

Plan for future expenses.

Plan for future savings.

Fixed and Flexible Expenses

Expenses are part of life. A budget helps monitor and control them.

There are two main types of expenses: fixed expenses and flexible expenses. Fixed expenses, such as rent, a car payment, or tuition, are necessary and generally do not change from month to month. Flexible expenses, such as buying video games, paying for car repairs, or purchasing new clothes, are non-necessary or unplanned spending. Sometimes, flexible expenses can be adjusted or eliminated. At other times, however, they cannot be avoided.

Fixed expenses must be taken into account in a budget, because they rarely change and usually cannot be eliminated. Once the fixed expenses are paid for, there may or may not be much left for flexible expenses.

Short-Term Expenses

Fixed expenses cannot be avoided. They are part of life. The financial planning that takes care of these expenses is known as short-term planning. Short-term planning involves keeping track of and covering all fixed expenses such as food and rent.

Most consumers do not limit their budget to just the necessities. They also try to plan for flexible expenses like entertainment, gifts, trips, and unforeseen circumstances that are a regular part of nearly every consumer's spending habits. Short-term planning allows consumers to have enough money to do some of this discretionary spending.

Securing Your Future

Short-term planning takes care of expenses for necessities and some luxuries. But most people have financial goals that go beyond just meeting their day-to-day expenses.

To prepare for spending in the years to come, many people employ long-term planning. This kind of planning involves looking into the future to make wise decisions.

Long-term planning can seem a bit overwhelming. It can be hard to plan for spending that you will not do until 20 years have passed. But long-term planning has many important benefits. Wise consumers try to think about the long-term plan even though it can be difficult to predict the future.

What is Your Plan?

How about you? Have you considered your long-term expenses? Have you started saving money for college, or maybe for a down payment on a car? These are two common reasons for long-term planning.

Assets and Income

When consumers plan for the future, they pay attention to assets and income. An asset is anything a person owns that has monetary value. Personal assets can include cars, computers, jewelry, or a savings account. Income is the money a person gets, whether as a gift, a salary, or earnings from an investment.

Knowing your assets and income is necessary in helping you plan your budget. This, in turn, will affect the way you spend your money. For example, you could decide to invest in stocks this year. Five years from now, you may show a profit on this investment. That extra money can help pay for tuition. This is an example of how long-term planning can be effective. You can plan now for how your assets and income might grow in the future.

View Assets and Income. Sort each example into the appropriate column to show whether it is an asset or a form of income.

Financial Planning and Decision Making

Consumers engage in both short-term and long-term planning. Without short-term planning, you might have fixed expenses that go unmet. Without long-term planning, you cannot move toward your bigger goals such as going to college, owning a home, and eventually retiring.

Both short-term and long-term planning affect how consumers make decisions. What consumers spend now often depends on their plans for the next month, the next year, and the distant future.

View Financial Planning and Decision Making. Sort the following financial goals into the correct column below to make sure you understand the difference between short- and long-term planning.

Consumers in the economy are a bit like runners in a race. The runners each have a different reason for competing. Some may be happy just to be in the race at all. Others may be intent on achieving a personal best, while for others only winning the race will do. All the runners take part in the race to achieve some sort of satisfaction. They run to find fulfillment. Consumers buy goods and services for just the same reason. They want to find satisfaction when they participate in the economy.

What makes someone satisfied? Of course, the answer is different for everyone. Some people are content with little, while others can never seem to get enough. As one of the richest men in the world, Henry Ford was once asked, «How much is enough?» He answered, «Just a little bit more.»

Some want to win, while others are happy to participate.

Utility

Satisfaction cannot be easily measured. But because nearly all economic decisions involve consumers in search of satisfaction, economists try to understand it. They call a person's economic satisfaction utility. Utility is the amount of personal satisfaction consumers get from the goods and services they purchase.

For instance, if you buy a new CD and find that you really like the music on it, then you are satisfied. Your utility is high. If you do not like the music, however, you are not so satisfied. Your utility is low. The concept of utility applies to every decision you make when buying goods and services. It is an important factor to consider when looking at how consumers make decisions.

Remember that your measure of utility is quite different from that of others. Your utility depends on your personal tastes and preferences, your goals, and your individual situation. Someone else might love a CD that you did not like very much. Utility levels differ from person to person.

Some things can be weighed easily, but satisfaction is not one of them.

Utility and the Cost-Benefit Analysis

You already know that consumers use the cost-benefit analysis to make economic decisions. Costs and benefits can be measured in monetary or nonmonetary terms. Ultimately, costs are measured in satisfaction, or utility. Since each person's utility is different, different people make different decisions in the same situation.

Consider this example. Mike and Emily are in the same physics class. They are both having a hard time understanding the material, so the teacher offers to help them catch up after school. The cost to each of them is a few hours at the end of the school day. While the time commitment is the same for both, their utility may be quite different. Emily has other after-school activities that she does not want to miss. Mike has no other plans after school. The cost of this time is different to each of them. Their utility is different.

Different decisions result from different tastes and preferences.

The Road Not Traveled

When you make decisions as a consumer, you do not consider just one possibility. For instance, if you are thinking about going to a movie, you are weighing two different options: going and not going. Not going leaves you other options: reading a book, taking a walk, or playing a game with a friend. Every decision involves following one path and not following all the other possible paths.

So, a decision is not just about selecting something that has more benefits than costs. It is about selecting the option that gives the greatest amount of utility from among all the available opportunities. Consumers have to consider the benefits lost as a result of their decisions.

Think of a farmer who decides to grow corn on his land. His opportunity cost is the alternative crop that might have been grown. What if he decided to grow wheat instead of corn? Would he have made more profit? Since he decided to grow corn, he gave up the alternative to grow wheat. He

considered both options before making his decision, and in the end, he thought that it would be more profitable to grow corn.

Utility and Incentive

To maximize utility, consumers and producers look at incentives. These are the factors that motivate or influence human behavior.

Incentives can be monetary or nonmonetary. If you work very hard at your job, you might get rewarded with a bonus or a pay raise. Your employer is giving you a monetary incentive to work hard. If your hard work earns an extra week of vacation instead, that is a nonmonetary incentive. Because utility is a person's satisfaction, an incentive can raise utility whether it is monetary or nonmonetary.

Incentives increase the possible benefits of a decision. As such, they affect the cost-benefit analysis a consumer might make.

Most people would agree that a bonus is a better incentive than a pat on the back.

What Drives You?

When you look at opportunity costs, you consider monetary and nonmonetary incentives.

If you reduce your part-time work hours to do volunteer work in your field of study, you will decrease your monetary benefits but probably increase your nonmonetary benefits. The volunteer work helps others and makes you feel good. This decision could also have a monetary effect; the experience you get from volunteering might help you get a better paying job in the future.

Untangling and calculating the monetary and nonmonetary incentives can be tricky. As a consumer, you do it all the time when you make decisions.

Marginal Analysis

Consumers try to boost their utility by making decisions that maximize satisfaction, or benefits, while minimizing costs. You have seen that cost-benefit analysis and paying attention to opportunity costs help consumers figure out what decision will be best.

Consumers also use marginal analysis when they make decisions. Marginal analysis helps answer an important question: What happens if the situation changes by one unit of something? Economic players ask themselves this question in one way or another all the time.

Consider this situation: The latest summer blockbuster has gotten some pretty bad reviews but seeing it will give you a chance to do something with your friends. Besides, tickets for a matinee are only $5. The utility you will receive from that purchase seems high.

But what if you get to the theater and discover that the ticket prices have been raised by $1? It might still seem worth it to go. But it is also possible that the extra dollar pushes the cost higher than the benefit. If that is true, then your utility has decreased, and you likely will choose not to go.

Will you see the movie for $6? How about $7? What about $8? At a certain point, the price will rise high enough that the cost outweighs the benefit, and your decision would change. That is marginal analysis.

Producers Thinking Like Consumers

Even though they may be unaware of it, consumers use marginal analysis when they make economic decisions. For every good or service, there is a point at which consumers change their minds about making a purchase if the price gets too high. Consumers are not necessarily aware of the fact that it was marginal analysis that led to that decision.

Producers, on the other hand, pay close attention to marginal analysis. They hope to maximize profits, which means they want as many customers as possible to pay the highest price possible. To achieve this, they try to predict consumer behavior. Producers ask themselves questions such as, «Will raising ticket prices by $1 drive away moviegoers, or will most consumers be willing to pay that much more?»

Producers use marginal analysis all the time. When producers can increase the utility of consumers, they sell more goods and services. When they can get the most out of consumers, they will maximize profits.

Producers study consumers to see how they make decisions.

More Than Price

Marginal analysis can be applied to other questions as well. Any time one more unit of something can be added, the question of whether it is beneficial to do this must be asked and answered.

A bank manager looks a bit worried. Her customers seem to be waiting a bit too long before they are served by a teller. What if she hired one more teller? The waiting time would decrease, and her customers would be more satisfied. If the customers do not have to wait very long, it is highly possible they will return to the same branch.

A hungry customer has already eaten three plates of sushi. He is considering ordering one more plate and uses marginal analysis to compare the pros and cons of doing so. He knows that he might not enjoy the fourth plate of sushi as much as he enjoyed the first three. And he does not want to get sick from overeating. In the end, his marginal analysis tells him to forgo that fourth plate.

David is a city council member. The council needs to vote on a one cent increase to a local tax. David and another city council member want to vote in favor of the tax increase. The extra money will allow the city to replace a worn-out playground at a neighborhood park, which would be beneficial to local residents with children. A third council member is against the tax increase, because not all residents will benefit from the new park, and she thinks the money could be spent in a better way. Marginal analysis is different from person to person because everyone has individual goals and values.

Everyone is unique. It is what makes people separate individuals, each with their own likes and dislikes. In the game of economics, this uniqueness means that consumers have different tastes and different preferences when it comes to buying goods and services. Look at all the brands and types of cereals in a grocery store. That should give you some idea of how diverse consumers' tastes are.

Consumer decisions are influenced by many factors. Taste is just one of them. See the list below for some of the nonmonetary factors that influence consumers.

– Taste
– Culture
– Beliefs
– Values

Beyond Money

Culture, family traditions, and personal values all affect consumer decisions. These factors are nonmonetary incentives.

When a family celebrates Thanksgiving, they make economic decisions that might be influenced by the desire to cook the perfect meal. So, they might ignore other factors, like price, because they gain more utility from the feast itself than from cutting costs. The nonmonetary incentive of hosting a great Thanksgiving meal outweighs monetary incentives – at least to a point.

The combination of cultures, beliefs, and values leads to different kinds of decisions being made by different consumers, even when they face the same situation.

Working together as a family offers incentives that go beyond money.

Culture Matters

The desire for particular goods and services is often influenced by a person's culture.

Part of the culture of the United States is Independence Day, or the Fourth of July. Thanksgiving is also important in the United States. Because of these features of the culture, consumers buy a lot of fireworks in early July and a lot of turkeys in late November.

How Culture Influences Consumerism

As we learned before, our economic decisions are based on what culture or cultures we belong to. Culture is more than just holidays and sports, though. For instance, the rock-and-roll culture is highly present in many countries around the world. People who belong to this culture enjoy dressing

like rockers, buying and listening to rock music, attending concerts given by their favorite bands, and collecting memorabilia.

Traditional Native American cultures consider humans an integral part of the environment, not a dominating force. They are closely tied to natural resources and events, and they value and respect nature. For example, they avoid over-consumption of water or lumber in order to protect lakes and forests. They also value self-sufficiency, and often produce their own goods and services through gathering, hunting, and fishing.

We do not necessarily have to be part of a culture to celebrate it. For example, St. Patrick's Day is an important holiday in Ireland, but it is also widely celebrated all over the world. On March 17 of every year, people of all different cultures can be found wearing green and making merriment. Producers take advantage of the universal appeal of St. Patrick's Day to market and sell specific products, such as green clothing, festive decorations, and even green food. In this case, St. Patrick's Day has become an adopted culture for many.

Values and Beliefs

Culture is more than just holidays and traditions. Different cultures have different values and beliefs that influence their members' behavior.

Values and beliefs are linked. If you value a clean environment, then recycling is likely to be a part of your value system. Your behavior is guided by that value. If you believe that free trade is the best kind of system, then you would not mind buying leather shoes from Brazil or a pair of jeans imported from Italy. If you believe in supporting local businesses, on the other hand, you might buy only locally grown fruits and vegetables.

Producers try to understand consumers' values and beliefs when allocating resources, because values and beliefs affect the way consumers make economic decisions.

For example, recycling is an integral part of South Korean culture. The government makes sure that recycling bins are available across the country, and it employs officers who routinely check to make sure people put their refuse in the correct bin. Because this is an important value among South Koreans, producers there try to make eco-friendly products to increase the sense of utility among consumers.

How green are you?

Risk Aversion

Every economic decision a person makes contains some sort of risk. Some decisions are less risky than others. If a college student puts $5 in a savings account, there is little risk, but also very little reward. Her money is safe, but it will not grow fast. If, on the other hand, she uses the $5 to buy a lottery ticket, she is taking a big risk, with the possibility of a great reward. Most likely, she has lost the $5 forever. But there is a slight chance she will win millions.

Many people play the lottery. Many others do not. This is because everyone has a unique level. Some people will always choose the less risky option, even if the possible reward is small. Other people will go with something far riskier in the hope that they will get a big reward.

It is common for people to have a high level of risk aversion. Security is an important value to many people. But many people have low levels of risk aversion. These risk takers make very different decisions than people who prefer to play it safe.

Here is one example of risk aversion. Suppose you loaned a friend $300 last month. Today, he offers to pay it all back, or to invest it in his Internet company. You have a high level of risk aversion if you prefer that he pay you the $300 now. You are not sure how profitable his business will be, so to you it is not worth taking the risk. You have a low level of risk aversion if you decide to let the $300 ride and see if you end up with more in the long run.

There is no such thing as a safe bet.

Let us Talk About You

Cultures, values, beliefs, and risk aversion all play a part in the economic decisions that people make. People do not even have to be consciously aware of these factors. They just do what seems right. This does not mean these factors are not influential. It just means that many consumers are not conscious of their influence.

You can see the influence these factors have more clearly if you think about your own views. Do you know what your value and belief system is? Do you ever think twice about making an economic decision based on what you believe in?

The media has all sorts of messages for us. At times it can feel like a constant bombardment from the television, the phone, and the Internet, not to mention the radio, magazines, mail, billboards, and all the other ways that words and pictures are hurled at us. It is almost impossible to escape the media.

Think of the many advertisements for products and services you see in just one day. Could you even count them all? In addition, you get warnings, instructions, questions, information, and all kinds of other messages.

Communication is an important feature of human behavior, and the media's primary focus is communicating one message or another to consumers.

Types of Media

Companies use the mass media to communicate information about their products and services to a large number of people. Producers are aware that consumers are the ultimate decision makers in the game of economics. Producers, however, also know that the mass media can be a powerful method of persuading consumers to buy their goods and services. Take a closer look at how this works.

Traditionally, news media is a subset of mass media with its own content and purpose. In recent years, however, the lines between general mass media and news have blurred.

Influencing Consumer Behavior

Television, magazines, and other media can be highly influential. Popular sitcoms create images of consumption that inform our own consumer behavior.

Consciously or not, some people adopt the styles, fashions, and even attitudes of their favorite TV characters. Some consumers make decisions based on their desire to look or live in a way that resembles the lifestyles they see on TV.

Magazines can have a big effect on consumer behavior, as well. Fashion magazines influence some women's perception of beauty and influence the products they buy. Men's magazines also influence how men see themselves. They have articles that include news, sports, men's fashion, and even lists of the top outfits men should have in their closets.

Some people adopt the styles they see on their favorite shows.

Mass Media

Mass media has a big effect on how consumers view themselves.

Companies advertise their products and services in all forms of media. This is done indirectly through product placement and directly through advertising.

Advertising is the biggest method used by producers to influence consumer behavior.

There are many methods and techniques of advertising. You are probably familiar with most of them already. TV commercials, magazine ads, billboards, and even signs on the sides of buses all infiltrate our lives on a daily basis.

On the Internet, most Web pages contain advertising, often including pop-up screens and animations. You can get advertising delivered directly to your cell phone, too.

It pays to advertise.

Over the years, the sophistication of advertising techniques has advanced, as have breakthroughs in communication technology. Many people use the Internet every day and depend on it to get information. This makes the Internet an enticing vehicle for advertisers. Unlike radio, television, and print sources, the Internet is a nonlinear form of media, making it possible to advertise

in various ways. Banner ads, pop-up windows, corporate Web pages, and bulk e-mails are some of the methods used.

Advertising Strategies

The main purpose of advertising is to get consumers to demand more goods and services. There are many ways to do this. One is to create a need for a product by emphasizing the connection between a product and a certain aspect of life.

For example, most people want to be clean. Soap and shampoo are needed to be clean, but is that all? If advertising can convince consumers that they also need deodorant and conditioner to feel clean, then more people will buy deodorant and conditioner.

Advertisers can also succeed at increasing demand by getting people to see luxuries as necessities. This is usually just a perception – you think you cannot live without something when, in fact, you probably can.

The Brand-Name Game

In our fast-paced world, producers know that consumers like to find what they need quickly and conveniently. Today, you can order a product online from anywhere in the world and have it delivered to your house in a matter of days.

This leads to a lot of competition among producers who want consumers to buy their stuff. This is another purpose of advertising – to get people to choose a specific product or service instead of the same thing provided by a competitor.

One method used by companies to get people to buy their products instead of someone else's is branding. Branding gets people to recognize a particular company's product and associate it with quality and popularity. Some brands can even succeed in becoming common names for the products they sell, such as Kleenex or Band-Aids.

Branding is not the only method that advertisers use. Advertisers know that consumers are more likely to buy products that they identify with, so they make ads that appeal to people by telling a story or connecting the consumer to the product.

Some brands are so familiar that we use their names generically.

Adverse Advertising

People get their news mostly from TV, newspapers, the Internet, and the radio. When it comes to informing the public on goods and services, the news media can be an effective and powerful tool of communication. When a new product comes out, like the latest car, gadget, or toy, the news media will likely discuss it, providing another form of free advertising.

News stories also alert the public to defects, dangers, and recalls. This kind of negative exposure also influences consumers by getting them to avoid certain goods and services and to beware of dangers in general.

Producers Influencing Consumers

Consumers make the final choice in all purchases, but producers do not want to leave all of the deciding up to consumers. They want consumers to demand more goods and services, and they want consumers to choose their products over those offered by someone else. Producers try to influence what consumers think and do to increase demand for their products so they can beat out the competition.

Consumers are the driving force of the economy, but they cannot do it alone. Without producers, there would not be anything to consume. To have consumption, there needs to be production. That is why businesses are important.

Businesses come in all shapes and sizes, from small home businesses run by one person to large international corporations that employ thousands of people in dozens of countries.

In many ways, businesses are like consumers. But there are important differences too. You will study some of these key differences and learn more about the role of businesses in the economic system.

Producers make all kinds of economic decisions. Just like consumers, they use rational choice when they do. In fact, producers are often more likely than consumers to pay close attention to the rationality of their decisions.

Usually, there is a lot more risk for producers when it comes to decisions. As a result, producers have significant incentive to use cost-benefit analysis and other tools of financial management. If they do not make good decisions, they will not make money. If they do not make money, they will go out of business.

Producers try to be as rational as possible, so they can keep playing their role in the economy.

Producers and Rational Choice

Remember that rational choice is a decision-making process that compares the benefits and costs of an action. Rational choice is a way of looking at several potential choices and deciding which choice is the best.

You have seen how consumers do this. Producers do the same thing, though there are some important differences. For one thing, businesses consider benefits and costs just as a consumer does, but only the monetary costs and benefits are relevant to their calculations. Consumers often take into account non-monetary things when doing cost-benefit analysis.

For instance, a farmer decides which crops to grow just like a consumer decides what to eat for dinner. But while the consumer might consider nonmonetary factors, the farmer is going to focus on monetary considerations.

Consumers might think about what is cost-effective when planning dinner, but they probably also prioritize nonmonetary considerations, such as what they like to eat or how healthy the food is.

Farmers do not think about what they like to eat when deciding which crops to grow. A farmer's food preference does not affect production decisions. What farmers do pay attention to is how much money it will cost to plant various crops and how much they can expect to earn by selling those crops. Whichever crop will have the highest expected return is the crop the farmer will plant. It is the rational choice in monetary terms.

Profit

Monetary calculations are central to any producer's decision-making process because making money is the reason businesses exist in the first place. In a market economy, businesses are free to make as much money as they can.

To make a profit, a business must have more revenue than costs. This means a business must earn more from the sale of its goods and services than it spends producing those goods and services. Here's a simple formula that shows how to calculate profit:

Revenue – Costs = Profit

Profit is often called «the bottom line» because it is at the bottom of the calculation. The calculation of profit can be a bit more involved than simply subtracting costs from revenue. There are different types of expenses – production costs, administrative costs, taxes, and so on – that are calculated and subtracted in different ways.

For example, imagine a lemonade stand that rings up $30 in sales on a particularly hot day. Making and distributing the lemonade cost $7. You can calculate profits with a simple equation:

$30 (revenue) – $7 (costs) = $23 (profit)

The lemonade stand made $23 profit.

The Profit Motive

Making profit is not just something businesses like to do. It is something they have to do.

Every producer must make a profit in order to remain in business. Without profits, businesses disappear. This gives producers the profit motive, which tells them that they have to minimize costs and maximize monetary benefits. This is not exactly a law of economics, but it is so universally followed that it might as well be.

The profit motive is a necessity. Producers who choose to ignore profit end up going out of business. Only those businesses that have the profit motive will remain in business. You can easily say that all businesses are driven by the profit motive because they do not have any other choice.

Profits and Losses

A free-market economy is driven by businesses' desire to make a profit. Businesses make production, pricing, and hiring decisions based on that goal. A business that keeps costs low and brings in more money than it spends makes a profit.

If costs and revenues are equal, the business is just breaking even. And when costs are higher than revenue the business is running at a loss. A business can break even or run at a loss for only so long before going out of business.

Even when a company is making a profit, the profit motive is an incentive. Because of competition, there can be pressure to make greater profits the next year. When other companies are increasing their profits, a business can fall behind even if its revenues are above its costs.

Imagine that you own a small bakery. You manage to sell enough cakes, rills, and doughnuts so that your revenues are greater than your costs. You can pay the rent, buy supplies, and pay your employees, and still earn a profit at the end of each month.

But what if your rent goes up? To break even at the end of the month, you increase the price of your goods. In this case, your revenues are equal to your costs. You are not making a profit, but you can continue with your business.

If you want to continue making a profit at the end of the month, you have to increase the price of your goods even more. Unfortunately, your customers might choose to stop buying your baked goods. In this case, you experience an economic loss because your costs are greater than your revenues.

The profit motive drives businesses to do two things:

– Reduce costs whenever possible

– Increase sales whenever possible

Inputs and Outputs

Profit is revenue minus cost. Simple. But what brings in revenue? And what counts as cost?

Revenue is all of the money a business brings in by selling its goods and services. In other words, it is the money derived from its output. For a business to have output, it needs input.

Inputs are what go into production. They can include the land, labor, and capital that are needed to produce any good or service.

Inputs cost money such as wages for workers, rent for land or capital for raw materials and equipment. They involve monetary costs for businesses. A producer's costs account for all of the inputs necessary for production.

Opportunity Costs

Because profit dominates a producer's thinking, businesses have to pay close attention to inputs and outputs. This involves making rational production decisions.

Consumers consider opportunity costs to make rational decisions. Businesses do the same. Remember that this is the cost of opportunities that are passed up when deciding to do one thing instead of another.

Business decisions about opportunity costs involve determining inputs and outputs. For example, if you have decided to open a bicycle factory, you have to decide what kinds of bicycles to make. You also have to decide what to use to make your bikes. Say you decide to make aluminum mountain bikes. The opportunity cost of that decision is what you earn making steel mountain bikes, aluminum children's bikes, or any of the various combinations available. *could*

Production Possibilities Frontier

Businesses do not just try to guess about opportunity costs. Guesses are often wrong, and wrong answers lead to losses, not profits. Producers need a better tool of analysis. One tool is the production possibilities frontier, also known as the PPF.

A production possibilities frontier is a graph that shows producers how to set up production in an efficient manner. Efficient production allows a producer to maximize profit.

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Working With the PPF

This graph represents the PPF of a bicycle-making business. The red line shows how many of each bike can be made with the inputs available, such as workers, aluminum, plastic, and other supplies in the factory. The points A, B, and C represent the points at which production of mountain bikes and racing bikes is the most efficient.

This table shows when production is the most efficient. Points A, B, and C show some of the many possibilities of producing bicycles where production is maximized. A maximum of 150 racing bikes and 200 mountain bikes can be produced given the set of inputs available.

Let us a look at that PPF graph again for an example of inefficient production. Point X shows an inefficient use of inputs. By making only 100 of each bike, the available workers and materials are not being used efficiently. No producer would want to choose a level of output that falls below the PPF. As long as the points of production stay on the red line, production is maximized.

How can you decide whether A, B, or C – or any other point on the PPF – is the best one? They are all equally efficient. However, unless mountain bikes and racing bikes sell for the same amount, one decision could lead to more revenue than another. To make a fully rational decision, the prices for each bike must be taken into consideration. The PPF cannot predict price so its usefulness is limited, but it is

still an important tool for creating efficient production.

Market Research

The PPF shows a producer how to maximize efficiency, but there is more to making a rational decision than efficiency. Getting the most output from your inputs – productive efficiency – gives you the possibility of maximum revenue with minimum cost.

Consider the previous example. The PPF tells us that any of the three mixes of production will be efficient.

But which one will generate the greatest revenue? Rational choice always requires information. To get this kind of information, producers do market research.

Producers can decide which type of efficient production will also be profit-maximizing production by

– Researching the price of competing goods in the market.

– Finding out what consumers are willing to pay.

– Determining whether consumers want or need what is being offered.

Getting the Profit Motive

Profits drive producers. After all, making a profit is the reason people start a business in the first place. Producers make decisions that are aimed at maximizing efficiency and profits. Making these decisions requires a lot of information about production and the potential market.

In a free-market system, producers are free to make decisions. This freedom creates competition among businesses as they pursue the same goal of selling goods or services.

A typical example of competition is the long-running contest between soda products Coca-Cola and Pepsi. The two companies that produce these popular beverages have engaged in direct competition with each other for over 100 years. Of course, there are lots of other drinks available, too, and Coke and Pepsi compete against all the available options for the biggest share of the multibillion dollar soda market.

Businesses want as big a share as possible in order to maximize profit. They clash in the free market to get consumers to purchase their goods and services instead of those offered by their rivals. Competition pushes businesses to be as efficient as possible so they can offer the lowest prices. It also drives them to develop new products and services in order to keep attracting new customers.

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What Kind of Competition?

Competition is a clash of rivals pursuing the same goal, but not all competitions are the same. The way rivals compete depends on their goals and the number of competitors.

In a football game, for instance, two teams compete to score the most points. In a 100-meter race, on the other hand, there might be as many as nine runners competing against each other, and also the clock. While there is no victory for finishing in second place in a football game, in a foot race there is. You may not be the very fastest if you place second or even third, but you have beaten many competitors.

Businesses compete to make as much profit as possible. The amount of profit they can make depends on the kind of competition they face. The nature of competition faced by different businesses in different markets is known as the market structure.

Different markets are like different sports. The nature of the competition depends on the number of competitors. The competitors are always trying to maximize revenue and profit, but the number of other businesses selling the same things varies.

Economic competition comes in two different types: competition among the few and competition among the many. In a market with only a few producers making a specific thing, each producer has some control over the price. The distinction between a few producers and many producers tells us about the basic market structure.

But we can be even more specific about the types of competition. One extreme type of market structure is called a monopoly. When only a single producer sells a good or service, there is no competition at all. That is a monopoly. In a monopoly, the consumer is stuck with whatever decisions the producer makes, because there is no rival product to choose.

Oligopoly is another market structure characterized by few sellers. There are more producers than in a monopoly, but the range of businesses is very limited, and consumers have to choose from a short list of providers. Oligopoly offers some competition, but producers do not have to worry very much about competition.

At the other end of the spectrum of market structures is pure competition. In a purely competitive market, there are numerous businesses, and there is a wide variety of products sold. In a purely competitive market, consumers have a wide range of choices, and producers have to find

ways to beat out their rivals. All this competition results in a lot of innovation, incentives to be efficient, and lower prices.

Pure Competition

The market structure that works best for consumers is pure competition. Pure competition is an ideal market structure that does not actually exist anywhere in the real world. We can, however, use pure competition as a standard for analyzing the market structures that do exist.

A purely competitive market has

– A large number of small businesses.

– Identical or easily substituted products.

– Freedom of entry into and exit out of the industry.

– Perfect knowledge of prices and technology.

Even though pure competition does not actually exist in the real world, there are places where it is close. The company eBay, an online retailer, created a marketplace on the Internet that functions with a market structure that comes quite close to pure competition.

Consumers can buy almost anything on eBay in a pure competition market structure. Pure competition exists when identical products are sold.

The sellers or producers on eBay set a minimum price for their goods. The consumer can then bid for the goods of his or her choosing. In this case, we have pure competition because everyone has perfect knowledge of the prices set.

Monopoly

Pure competition and monopoly are two extreme types of market structure.

While pure competition allows for perfect competition among a large number of sellers, a monopoly creates a total lack of competition. The monopoly has complete control over its market. This gives the producer complete control over what products to provide and what prices to charge.

The characteristics of a monopoly are

– A single producer.

– A unique product with no close substitutes.

– A price controlled by the producer.

– Entry is blocked to competitors.

The Near Monopoly

A pure monopoly is nearly as rare as pure competition. Most actual monopolies, such as a city's utility provider, are heavily regulated by the government.

But there are some companies that control a particular market so thoroughly that they come close to creating a monopoly.

Microsoft is one of these near monopolies. While Microsoft is not a monopoly by definition – Apple also creates operating-system software – Microsoft dominates the market so effectively that it has been accused of acting like a monopoly.

The Microsoft Monopoly

Bill Gates and his company Microsoft control the market when it comes to operating systems, such as Windows 95, Office 2003, and other software applications.

Did you know that 90% of the world's personal computers run on Microsoft software from the minute they are turned on? Microsoft has managed to automatically set up its operating systems in most computers being sold in the world. It has a monopoly, because its products are unique, and its rivals cannot compete against it. Microsoft is also able to control the price of its operating systems because there are no similar products on the market.

In 1998, a court case was filed against Microsoft Corporation. Microsoft rivals accused Microsoft of abusing its monopoly in the way it sold its operating systems and web browsers. The main issue was whether Microsoft was allowed to sell its Internet Explorer web browser software with its Microsoft Windows operating system.

Many technology companies have fought legally against Microsoft's monopoly, including Apple Computer, Netscape, and Sun Microsystems. However, Microsoft still holds the majority of the market of operating software. It has the monopoly, because it has blocked the entry or has made it very difficult for competitors to enter the same market.

Monopolistic Competition

Monopolistic competition is a market structure that includes many producers providing products or services that are almost the same, but not quite identical.

A market structure of this sort allows some price control. But businesses generally accept the prices charged by rivals, ignoring the impact of their own costs. Monopolistic competition resembles pure competition except that different producers are selling similar products.

Oligopoly

In a system of monopolistic competition, there are a large number of small businesses. In an oligopoly, there are a small number of large businesses dominating a particular market. Businesses keep a close eye on the decisions made by the few other businesses in the industry.

Because there is not much competition, businesses in this type of market do not change prices often. In order to attract customers away from the small number of competitors they face, businesses in an oligopoly offer incentives, including bonuses and rebates.

The characteristics of an oligopoly are

– An industry dominated by a small number of large businesses.
– Businesses sell either identical or slightly differentiated products.
– Businesses give incentives instead of changing prices.
– Significant barriers exist to enter industry.

Oligopoly Models

Oligopoly is a common market structure because many industries are difficult to break into. Anyone can open a lemonade stand with just a few dollars, but it takes millions and millions to build and operate a car factory. As a result, lemonade is a pretty competitive market, while the automobile industry is an oligopoly.

The automobile industry is considered an oligopoly because it is dominated by a small number of large companies. These companies all sell similar cars, such as four-door sedans, minivans, and SUVs.

Another good example of an oligopoly is the airline industry. This industry is dominated by a small number of large companies. These businesses offer their customers similar products. However, certain airlines go to certain cities, while others do not. Airline companies also have incentives to attract customers, such as ticket upgrades or free air miles.

Considering Competition

Businesses compete with each other as they pursue the profit motive, but they take into account the type of competition they face before they make decisions.

The four different market structures you have examined show the differences between the competitive situations faced by producers operating in different markets.

Remember that the level of competition varies depending on the number and size of competitors, the type and quality of their products and services, and their degree of market control over price.

The continuum of market structures

Market Structure Review

From the largest corporation to the humblest small business, participating successfully in the free-market system requires a good plan, lots of determination, and the willingness to take some risks. A person who starts a new business is a risk taker. We call these people entrepreneurs. An entrepreneur is an individual who begins, manages, and bears the risks of a business.

Entrepreneurs play an important role in economics by offering consumers new ideas, new products, or new services. They compete in existing markets and sometimes create entirely new markets. Entrepreneurship is difficult and risky because many new businesses fail. But when successful, entrepreneurship contributes to the growth and prosperity of the overall free-market economy. Entrepreneurs create jobs and encourage a greater exchange of goods and services.

An Entrepreneur's Motivation

There are many reasons why entrepreneurs decide to start a business. Henry Ford wanted to produce cars more efficiently; Oprah Winfrey wanted to help people make their lives better; Steve Jobs wanted to provide customers with user-friendly personal computers and new entertainment ideas. These are just three examples of innovative and successful entrepreneurs. Entrepreneurs often share common motivations. The also share common characteristics.

Motivations and Characteristics of Entrepreneurs

– Entrepreneurs like to work for themselves. **Autonomy:**

– Entrepreneurs are driven by their quest for profits. Successful entrepreneurs can create wealth rapidly. **Profits:**

– Entrepreneurs have a low level of risk aversion, since investing money in their own businesses is very risky. **Risk:**

– Entrepreneurs need innovation in the product, service, or business process in order to be successful. **Innovation:**

Innovation

One key to becoming a successful entrepreneur is innovation. The development of new devices, ideas, or ways of doing things helps entrepreneurs sell more goods or provide more services. Innovation is how businesses create new solutions to satisfy their customers' needs and wants. Innovation includes the creation of more effective products, systems, services, or technology.

Entrepreneurs' Innovations

Entrepreneurs innovate by creating

– New products.

– New production methods.

– New markets.

– New sources of supply.

The Innovation Game

Entrepreneurs innovate by introducing new means of production, new products, and new forms of organization. Innovations consist of inventions, discoveries, and new methods of production. Sometimes, innovations can change the entire economy.

One of the biggest business sectors in the world is the media industry. The media provide a service that nearly every person consumes in one way or another.

Because the media are a part of nearly every consumer's life, they are important to producers. Businesses use the media to advertise their message to potential customers. Almost every business relies on the media in some way to stay in business.

Unlike some businesses with a specialized customer base, media companies can sell to everyone – consumers and producers alike.

If a satellite turns in the desert and there is no one there to see it, does it still reach thousands of viewers?

Advertising Dollars

Media companies can make money by selling magazines, newspapers, televisions subscriptions, Internet services, and more directly to consumers. But for most media companies, the bulk of their profits come from selling advertisements. In fact, the mass media and news media make 90 percent of their revenues from advertising. If it were not for advertising, most media companies would not exist.

Businesses spend a lot of money on advertising. In 2012, companies spent more than $152 billion on advertising in the United States and more than $490 billion worldwide.

What Advertisers Are Buying

Advertisers pay a lot of money to media companies, but what exactly are they buying? In one sense, they are simply purchasing time or space: ink on a page, pixels on a screen, or 30 seconds of time. But what advertisers are really paying for is the audience – viewers, listeners, readers, browsers, or whoever might be exposed to the ads. Advertising is all about buying access to an audience.

Media companies provide content – shows, articles, information – to attract an audience so that they can turn around and sell that audience to advertisers. In the world of the media, the consumers are also the product.

How Visible Is It?

Because they pay high prices to advertise their goods and services, businesses want as many people as possible to see their ads. Visibility is an important measurement.

Businesses try to advertise in places where they feel they will have high visibility in front of a large audience.

Visibility is determined by a few factors. One is the size of the advertisement. A full-page image attracts more attention than a half-page image, so a full-page advertisement costs more. A one-minute commercial is more expensive than a 30-second commercial because it has greater visibility.

Another important factor is popularity. Popularity determines the rate for a specific amount of advertising space. If a lot of people read a particular magazine, then a full-page ad will be expensive. If only a few people read it, that same page will be much less expensive.

Expensive Advertising Slots

The Super Bowl regularly has the most expensive advertising on television. A 30-second commercial during Super Bowl XLI costs $2.4 million – that is $80,000 per second. Because of the high cost and high visibility of these ads, advertisers often use the Super Bowl to show innovative or unusual commercials or to launch new ad campaigns.

The Olympics is another sporting event with high visibility. Ad rates vary depending on the time of day, but the average cost of a 30-second commercial during the 2006 Olympics was $700,000. That is a lot less than a Super Bowl ad, but NBC made a total of $900 million selling ads during that Olympics.

Popular TV series also command high ad rates. American Idol, one of the top-rated shows in recent years, charges as much as $700,000 for a single 30-second commercial. The same 30-second ad on CSI costs only $465,000. Survivor and The Apprentice each get $350,000 for a 30-second spot. As ratings drop, ad rates drop, too. ER charged $440,000 for a 30-second commercial in 2004, but its ratings went down the following year, so the rates went down to $400,000.

Measuring the Audience

The cost of advertising depends on the size of the audience and the size of the advertisement. The bigger the audience, the more it will cost a business to advertise to that audience. Advertisers buy access to the audience's attention, and more audience members means more sales, which means more money.

But how can advertisers know how big the audience is going to be?

What is the Medium?

The method of measurement of the audience size depends on the medium. It is easy to measure consumers on the Internet. A Web page can count the number of times a page has been viewed.

In other forms of media, the count needs to be estimated. For print sources, circulation counts the number of magazines or newspapers that are printed and distributed. Not every magazine or newspaper will actually get read by somebody, and some will get read more than once. However,

circulation is still a pretty good measurement of the size of the potential audience. For TV and radio, audience size is measured by a ratings system.

Advertising Outlets

Media companies are not limited to a single way of selling advertisements. In fact, the more ways they can sell ads, the more money they can make. Most media companies use a variety of methods to advertise.

Magazines and newspapers, for instance, have traditionally sold advertising to raise revenues while also charging subscription fees to people who receive the publication in the mail. With the advent of the Internet, many magazines and newspapers have continued to enjoy advertising revenues but have struggled to find ways to charge subscription fees, because so many websites are available for free.

American Media

People get the information they need to make decisions primarily from the media. People watch TV, browse the Internet, read newspapers and magazines, and listen to the radio. What they see, read, and hear affects how they think and choose.

There are thousands of media sources for people to choose from, but a large number are owned by a few large companies. These companies are known as media conglomerates. Their dominance of the media industry creates a market structure that closely resembles an oligopoly because a few large companies control nearly all the media industry.

Global Media Giants

The centralized global media system is a very recent development. Until the 1980s, the basic broadcasting systems and newspaper industries were domestically owned and regulated. Starting in the 1980s, the U.S. government, along with its Federal Communications Commission (FCC), began to deregulate, or remove the legal restrictions that had been in place on media and communication systems.

With the rise of satellite and digital technologies, deregulation resulted in the success of global media giants. There are only a few global media giants today.

The Internet Media Revolution

The Internet operates differently from other forms of media. Because it is relatively easy and inexpensive to build an Internet site, it is easy for many different producers to have an Internet presence.

Millions of people contribute to the information available on the Internet. The popularity of blogging, instant messaging, and social media sites means that more and more people get their information and entertainment from sources that are not controlled by large media companies.

Despite the possibilities of the Internet, many of the most popular websites today belong to large media conglomerates. While it may always remain inexpensive to put information on the Internet, the most popular websites will likely come from large global corporations.

The Business of Media Review

Media companies are unique types of producers. They create content for people to consume, but these consumers are themselves something that is sold to other producers who buy advertisements.

Media companies play an important role in the game of economics. They provide information that affects the decisions of consumers, and they provide advertising services that nearly every producer needs to purchase.

People start new businesses every day. It requires a lot of planning and organizing, not to mention hard work and determination. It also takes money. Potential business owners can use their own money. They can borrow it from the bank, take on a business partner, or have a third party, sometimes called a venture capitalist, invest what it takes to open for business.

There are many kinds of businesses. Some businesses only have one owner. Others have multiple partners who own the company together. In the end, all businesses try to accomplish the same goals: providing goods and services to satisfy the needs and wants of consumers.

The first thing any aspiring business owner has to do is decide which goods or services to offer for sale. The variety of goods and services available from businesses is wide, and new entrepreneurs are always trying to come up with new ideas about what to sell and how to sell it.

Sole Proprietorships

One way to start a business is to operate alone, with little or no help from anyone else. This kind of business is called a sole proprietorship. The owner of a sole proprietorship is completely in charge of the operation of the business. If there are other employees, the owner is the boss. The owner receives all the profits but also bears all the financial risks (that is, the losses).

Many entrepreneurs prefer to open a new business as a sole proprietorship. It is the most common type of business, and it is also the easiest type to build. Almost all small businesses are sole proprietorships. Many medium-sized businesses and large businesses begin as sole proprietorships but grow with success and add partners and investors.

The Risks and Rewards of a Sole Proprietorship

With a sole proprietorship, a business is much like an extension of the business owners. It has no separate existence.

There are many benefits to a sole proprietorship. For instance, business owners can make their own decisions without having to consult other people.

Another advantage is that business owner pay personal income taxes, not corporate taxes, on profits. This makes accounting much simpler. And, of course, business owners also get to keep all the profits.

But there are also downsides. A sole proprietor has unlimited liability. That means that the business owner is responsible for all the debts and financial losses of the business. If the business fails, the owner can lose all assets. This includes not just business assets like equipment and supplies, but also personal assets like real estate and savings.

Sole proprietors also need to have enough money to start the business in the first place. Some potential business owners borrow money from a bank to start a company, but this is risky because of unlimited liability. The bank can collect personal assets if an owner defaults on a small-business loan.

Partnerships

Another way to organize a business is to form a partnership with others. A partnership is a contract in which business partners agree to operate the company together by combining their money, knowledge, and time. Partners share profits based on their contributions.

There are two main ways of organizing a business partnership: as a general partnership and as a limited partnership.

A general partnership is much like a sole proprietorship except that each partner is fully responsible for the debts of the business, including debts incurred by the other partners. Every partner has an equal voice in running the business, and the partners have to consult one another to make decisions related to their business.

In a limited partnership, on the other hand, each partner has limited liability. The most each partner can lose is the amount he or she has contributed to the partnership. In a limited partnership, the business is managed by one or more of the partners, while the other partners are investors who rarely take part in any business decisions.

Failed Partnerships

Two partners decide to start a restaurant. Each contributes $10,000 to fix up an old building, hire servers and cooks, and buy supplies. After the first year, the business is failing. The restaurant is $40,000 in debt by the time it closes its doors. Under a general partnership, each partner is fully

responsible for this debt. If one partner only has $5,000 in her savings account while the other partner has $50,000, the partner with more savings can be made to pay $35,000 of the debt.

If this same restaurant had been a limited partnership, each partner would be responsible for only 50% of the debt. So, the richer partner only has to pay back $20,000 of that $40,000. If the other partner can only pay $5,000, some of the debt might go unpaid. This can happen in a limited partnership. Investors generally prefer limited partnerships so that they are not held fully responsible if the business incurs too much debt.

Pros and Cons of Partnerships

There are many advantages to a business partnership. First of all, partnerships are fairly easy to establish. Also, partnerships typically make it easier to raise money that can be invested in the business. That is why partnerships are the preferred type of business for some small companies. Instead of going to the bank and borrowing money, business owners can ask people to be partners and invest their money. Another advantage to a partnership is that there are rarely any extra taxes to file, just personal income taxes on any profit made.

Being held individually responsible for all the company's debts is one of the major disadvantages to a general partnership. General partnerships can also be difficult to operate because partners need to work together and agree on business decisions. What might be a simple decision with just one person in charge can become much more complicated with two or more people trying to agree. This difficulty is lessened within a limited partnership because business decisions are made only by the managing partner. Still, the lack of input into business decisions by the «silent» partners takes away control, leaving their investment in the hands of the managing partners.

Corporations

Another type of business is a corporation. Corporations are like partnerships in that they are funded and operated by more than one person. But a corporation has many people who invest, and few investors have as much direct control or responsibility in the business operations as they would in a partnership.

The investors in a corporation are not partners but stockholders. A stockholder is someone who owns a share in the corporation in the form of stock. Unlike partners, stockholders do not make the business decisions themselves, unless they own a majority of all available stocks. Usually, a corporation is run by a board of directors, who are elected by stockholders. The board of directors is responsible for managing the business and making the daily decisions required to operate it.

Stockholders

When compared to forming a business partnership, investing in a corporation is much easier and safer. Stockholders do not need to help make day-to-day business decisions the way partners do. Those business decisions are left up to the board of directors. If stockholders do not agree with the decisions made by the board, they can vote for new members or simply sell their stock and invest in another corporation.

Because stockholders own the shares of a corporation, many businesses in the United States face a situation known as «double taxation.» The government taxes both corporate profits as well as the personal income of all the shareholders when they receive dividends or distributions of corporate profits.

Investors who buy stock in profitable corporations usually receive dividends. A dividend is a portion of the company's profit paid on each share of stock. Investors who own a lot of stock receive large dividend payments.

Stockholders are also protected if a corporation fails. Unlike sole proprietors or partners, stockholders are not responsible for any of the corporation's debts.

Benefits of Being a Stockholder

A corporation is a legal entity. It has rights to buy, sell, trade, and own property. It must also pay corporate taxes. A corporation has many advantages for its owners and stockholders. One of those advantages is limited liability. As a stockholder, you cannot lose more than you initially invest.

When a company is doing well and paying high dividends, there are always other investors who want to buy that company's stock. This drives the price up. Stockholders can earn money in two ways: through dividends and by selling their shares for more than the original purchase price.

Still, investing by purchasing stock in a corporation can be risky. People who invest in stocks often lose money because they choose the wrong company.

What Kind of Corporation?

Sony, a popular electronics brand, is a good example of a public corporation. The general public can buy and trade Sony stocks and receive dividends. This also means that control of Sony is in the hands of whoever buys Sony stock on the open market.

Mary Kay Ash launched her cosmetic company in 1963 in Dallas, Texas. Over the decades, it has grown into a multimillion-dollar company, with over 800,000 Mary Kay consultants all over the world. Mary Kay is a private corporation. This means that the general public cannot buy Mary Kay stocks. Mary Kay's private stockholders and board of directors retain exclusive control over the operations of the company.

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