ECONOMICS
TODAY AND TOMORROW

Reading Essentials
and
Study Guide

Student Workbook
TO THE STUDENT

The Reading Essentials and Study Guide is designed to help you use recognized reading strategies to improve your reading-for-information skills. For each section of the student textbook, you are alerted to key terms, asked to draw from prior knowledge, organize your thoughts with a graphic organizer, and then follow a process to read and understand the text. The Reading Essentials and Study Guide was prepared to help you get more from your textbook by reading with purpose.
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THE BASIC PROBLEM IN ECONOMICS

KEY TERMS

**economics**  The study of how people make choices about ways to use limited resources to satisfy their wants (page 3)

**scarcity**   The condition that occurs when wants are greater than the resources to satisfy them (page 5)

**factors of production** The resources of land, labor, capital, and entrepreneurship that are used to produce goods and services (page 6)

**land**  The economic term for surface land and water and the natural resources that each contains (page 6)

**labor**  The human effort that is required to produce goods and services (page 6)

**goods**  Material objects that satisfy people’s wants or needs (page 6)

**services**  Actions or activities that satisfy people’s wants or needs (page 6)

**capital**  Manufactured goods that are used to produce other goods or services (page 6)

**productivity**  The amount of goods and services that results from the use of a set amount of land, labor, capital, and entrepreneurship (page 7)

**entrepreneurship**  Ability of risk-taking individuals to start new businesses or develop new products and processes in hopes of making profits (page 7)

**technology**  Advances in knowledge that lead to new and improved goods and services and better ways of producing them (page 8)

DRAWING FROM EXPERIENCE

At one time or another, you have probably been required to do a project for your science, social studies, or art class. What materials did you use? Who did the work? Did you use tools in making your project? All these questions are basic to the study of economics.

This section focuses on how people and societies make choices in their use of resources. The study of these choices and how people make them forms the basis of economics.

ORGANIZING YOUR THOUGHTS

Use the cause-and-effect diagram below to help you take notes as you read the summaries that follow. Think about why people make choices in the things that they buy.

<table>
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<th>Cause</th>
<th>Effect</th>
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<tbody>
<tr>
<td>Because resources are</td>
<td>people must make choices.</td>
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READ TO LEARN

- **Introduction** (page 3)
  Economics is the study of how societies use limited resources to fulfill their wants and needs.

- **Wants Versus Needs** (page 4)
  People sometimes have difficulty recognizing the difference between what they want and what they need. In the study of economics, however, “needs” are only the basic things that a person must have in order to survive. Everything else is a “want,” or luxury.

  1. What is the difference between a want and a need?

- **Choices** (page 5)
  Because resources are limited, not everyone can have everything he or she wants. People make choices about how to spend the money they have. Businesses make choices about what to produce and when to produce it. Societies make choices about how to use their resources. In the United States, for example, elected representatives decide how much money to spend on defense and how much on education. How people and societies make these choices is the focus of economics.

  2. What basic economic choice must people and societies make?

- **The Problem of Scarcity** (page 5)
  Choices are necessary because everything that exists is limited. Even if a resource is plentiful, there still are limits to what is available. At the same time, people have competing uses for these limited resources. The result is **scarcity**. Scarcity means that people do not have and cannot have enough resources to satisfy their every want. Scarcity is the basic problem of economics.

  3. What is scarcity and why does it exist?

- **Factors of Production** (page 6)
  When economists talk about scarcity, they are talking about the **factors of production**—that is, the resources needed to produce goods and services. Economists recognize the following basic types of resources as factors of production:
A. **Land.** To economists, this term means all the natural resources present on Earth. It includes actual land surface and the plants and animals that live on the land, as well as mineral deposits within it. “Land” also includes water and everything found in water.

B. **Labor.** This factor of production includes everyone who produces **goods** and **services.** Goods are items that people buy. Services are activities done for others for a fee.

C. **Capital.** This is manufactured goods that are used to make other goods and services. It includes machines, buildings, and tools. Capital combines with labor to increase **productivity**—the ability to produce more goods and services in better and faster ways.

D. **Entrepreneurship.** This refers to the ability of people to start new businesses, introduce new products or processes, or improve management techniques. It involves people’s willingness to take risks in the hopes of making a profit.

E. **Technology.** Technology describes the use of science to develop new products and new methods for producing and distributing goods and services.

4. How does technology differ from capital as a factor of production?
TRADE-OFFS

KEY TERMS

- **trade-off**  Sacrificing one good or service to purchase or produce another (page 12)
- **opportunity cost**  The value of the second-best choice that is given up when the first choice is chosen (page 13)
- **production possibilities curve**  A graph that shows the greatest combination of goods and services that can be produced from a specific amount of resources in a set period of time (page 14)

DRAWING FROM EXPERIENCE

Suppose that you want something very much but you do not have enough money to buy it. What would you do to satisfy your desire for this item? Would you save money by packing your lunch every day instead of buying it at school? Would you get a part-time job to earn extra money? Would you sell one of your possessions to raise the money you need? What sacrifices are you willing to make to satisfy your want?

This section focuses on the costs of the choices that people make by examining what economists call trade-offs and opportunity costs.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the difference between an opportunity cost and a trade-off.

```
Choice 1

Value

Choice 2

Value

Trade-off of Choice 1 = ______________
Opportunity cost of Choice 1 = ______________
```
READ TO LEARN

• Introduction (page 12)

The effects of the choices people make about how to use their limited resources can be long-lasting.

• Trade-Offs (page 12)

When people make economic choices, they exchange one good or service for another. In making a purchase, the good they are exchanging is money. Exchanging one thing to get the use of another is called a trade-off. You make trade-offs every time you use a resource in one way instead of another. The result of a trade-off is what you give up in order to get or do something else. The cost of getting or doing one thing instead of another is known as opportunity cost. You figure opportunity cost by considering what your second choice for using a resource would be if you were not using the resource in the way you have chosen.

For example, time is a scarce resource. There are a limited number of hours in a day and you must choose how to use them. If you use one-hour to study a school assignment, the trade-offs are all the other things you could have done during that hour. The opportunity cost is what you would have done for that hour had you chosen not to study. In other words, it is the opportunity that you gave up in order to study.

Knowing about trade-offs and opportunity costs can help you make decisions at all levels. You will be able to make wiser use of your resources if you are aware of the trade-offs and opportunity costs of your decisions. Businesses must also consider these factors when they make choices about investing money or producing one good rather than another.

1. What is the difference between a trade-off and an opportunity cost?

• Production Possibilities Curve (page 14)

Many businesses produce more than one type of product. However, even these companies make trade-offs and have opportunity costs. This is because of the choices they make about what combination of goods to produce. Economists use a graph called a production possibilities curve to show how much goods and services can be produced from a set amount of resources in a specific period of time. This curve helps businesses decide how much of each item to produce. It reveals the trade-offs and opportunity costs involved in each decision.

For governments, a classic example of trade-offs is how much of a nation’s resources to devote to military production and how much to civilian goods. The amount of military goods given up is the opportunity cost for increasing civilian production. A production possibilities curve shows how to make the most efficient use of resources. It is useful in locating the opportunity cost of following a certain course of action.

2. How is a production possibilities curve useful to business and government planners?
What do Economists Do?

Introduction (page 18)

Economics is a social science concerned with how societies use their scarce resources. However, economists do not make value judgements.

Economic Models (page 19)

To an economist, the word economy means all the activity that affects the production, distribution, and use of goods and services. Economists study specific parts of the economy by forming theories and gathering data. The theories that they use are called economic models. An economic model is a simplified representation of the real world. Economists test possible solutions to
economic problems by using these economic models. Businesses and government often use solutions tested on economic models to make decisions. The production possibilities curve discussed in Section 2 is an example of an economic model. Economic models visually show economic behavior.

In the real world, several economic factors may be changing at once. However, using economic models lets economists hold certain factors steady so that they can study the relationship between other factors. Therefore, an economic model does not show every detail of a real-world economic activity. It shows only the information needed to analyze the problem being studied.

Models help economists study the way the real world works. An economist begins with an idea about how something works. He or she then collects facts and tests the theory, or model, in the same way that other scientists test a hypothesis—that is, an educated guess or prediction. Testing a model lets the economist see if it represents reality under a certain set of conditions. If it does not, economists must develop and test other models to explain what is being studied.

Economists often use models to predict how people will react in certain situations. However, individual human behavior is not always predictable. A predictive model also may not apply when conditions are different.

1. What is an economic model and how is it useful to businesses and others?

[Schools of Economic Thought (page 22)]

Economists deal with facts. However, their personal beliefs and other factors may influence how they think about those facts and fit them into theories. Therefore, all economists will not agree on the best solution to a problem. Economists from one group or “school” of thought may believe that their theories are better at predicting a certain result than are the theories of other schools of economists.

Economists will also not tell you whether the results they predict will be good or bad. Those judgments depend on values. Values are the beliefs and characteristics that a person or group considers important. Economists will research an economic problem and will predict whether a proposed solution will work. However, they will not judge whether the predicted outcome of that solution is a good outcome or a bad one.

2. Explain how values influence economists and help group them into “schools.”
ECONOMIC SYSTEMS

KEY TERMS

economic system  The way in which a nation uses its resources to satisfy its people’s needs and wants (page 31)

traditional economy  A system in which economic decisions are based on customs and beliefs that have been handed down from generation to generation (page 34)

command economy  A system in which the government controls the factors of production and makes all decisions about their use (page 34)

market economy  A system in which individuals own the factors of production and freely make decisions about what to produce and what to consume. (page 35)

market  The voluntary exchange of goods and services between buyers and sellers (page 36)

circular flow of economic activity  An economic model that shows the factors of production and money as flowing continuously between businesses and individuals (page 37)

mixed economy  An economic system that combines the characteristics of more than one type of economy (page 38)

DRAWING FROM EXPERIENCE

What kinds of food does your school offer? Do businesses sell sub sandwiches, pizza, tacos, or other “fast food” on your campus? Are vending machines present? Who decides what foods students can buy at your school? Who decides what is sold at the school store? The answers determine the type of economic system that operates at your school.

This section focuses on the various types of economic systems that exist throughout the world by looking at their characteristics and differences.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about who decides the basic economic questions in each economic system.

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<th>Basic economic questions decided by</th>
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<td>Command Economy</td>
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<tr>
<td>Market Economy</td>
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<tr>
<td>Mixed Economy</td>
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READ TO LEARN

Introduction (page 31)

Individual nations have different economic systems, or ways of determining how to use resources to satisfy people’s wants and needs.

Three Basic Questions (page 31)

Different types of economic systems exist in the world. However, each system must answer the same three basic questions:

A. What should be produced? We live in a world of scarcity and trade-offs. If more of one thing is produced, then less of something else will have to be produced.

B. How should it be produced? In addition to deciding what to produce, an economic system must decide how to produce it. Trade-offs exist in the answers to this question, too.

C. For whom shall it be produced? The type of economic system determines how goods and services are distributed. In the United States, goods and services are distributed by a price system. People’s income determines their ability to purchase items. Other systems might share products equally among members of society, for example.

1. Explain how the price system determines how goods and services are distributed in the United States.

Types of Economic Systems (page 33)

Economists identify four types of economic systems. They differ according to how each answers the three basic questions of what, how, and for whom to produce. In the real world, however, no such “pure” systems exist. All economies are mixed to some degree.

A traditional economy is a system that answers the three basic questions according to traditions and customs. Things are done the way they have always been done. Everyone knows what is expected of them. Change is discouraged and production methods are often inefficient. Therefore, choices among consumer goods are rare.

A command economy is a system in which government leaders control the factors of production and make all decisions about their use. Individuals have little influence over how the basic economic questions are answered. An advantage of this system is the speed with which economic plans can be changed. However, because the government sets wages, people have no incentive to work hard or efficiently. A lack of consumer choices also exists.

A market economy is sometimes called “capitalism.” This is the opposite of command systems. Individuals own the factors of production. They decide what to produce and how to produce it. The market—the voluntary exchange of products between buyers and sellers—guides economic choices instead of tradition or government control. Competition gives consumers a wide choice of...
products and helps to determine how much they cost. Factors of production and money flow back and forth between individuals and businesses in a model called a **circular flow of economic activity**.

A **mixed economy** combines parts of a market economy and parts of a command economy. Private ownership of property and individual decision-making are combined with government regulations. Most of the world’s nations, including the United States, have mixed economies.

2. In which economic system does choice play the biggest role? In which two systems does it play the smallest role?
CHARACTERISTICS OF THE AMERICAN ECONOMY

KEY TERMS

capitalism  An economic system in which private individuals own the factors of production and decide how to use them within certain legal limits (page 41)
laissez-faire  A system in which government lets people and businesses make their own decisions without putting controls and restrictions on them (page 41)
free enterprise system  System in which individuals are free to own the factors of production and decide how to use them within certain legal limits set by government; another name for capitalism (page 42)
profit  The money left after all the costs of production have been paid (page 43)
profit incentive  The desire to make a profit, which motivates business owners to produce and sell goods and services (page 43)
private property  Whatever is owned by individuals or groups rather than by government (page 43)
competition  Rivalry among producers or sellers of similar products to win more business (page 44)

DRAWING FROM EXPERIENCE

If you wanted to start your own business, what would it be? Would you hire some school friends and paint houses during summer vacation? Could you bake cookies in your kitchen at home and sell them to a local store? Perhaps you already are in business, cutting lawns or shoveling snow from driveways or parking lots. Your ability to make these choices is a result of the American free enterprise system.

This section focuses on the six characteristics of a pure market system and shows how they are present in the American economy.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the six characteristics of capitalism.

[Diagram with the following labels:
- Limited _______
- Free _______ System
- Capitalism
- _______ Incentive
- Private _______
- Competition
- Freedom of _______]
READ TO LEARN

Introduction (page 40)

The American economy evidences six characteristics of a pure market economic system. This section describes those characteristics.

Limited Role of Government (page 41)

Another name for a market system is capitalism. Pure capitalism is called laissez-faire. This means that government lets people make their own economic decisions without interfering. Since the 1880s, however, the role of American government in economic affairs has increased. For example, government regulates the quality of certain foods, watches over the money and banking system, and inspects workplaces for hazardous conditions. In the U.S. capitalist system, individuals and businesses own the factors of production and decide how to use them, but within certain limits set by government.

1. How does the American economy differ from a laissez-faire system?

Freedom of Enterprise (page 42)

The American economy is both a capitalist system and a free enterprise system. This means that people are free to own and control the factors of production. Within certain limits set by government, you are free to go into any business you choose. These limits include zoning regulations, child-labor laws, and regulations concerning the disposal of hazardous wastes.

2. Why does the government put regulations and other limits on free enterprise?

Freedom of Choice (page 42)

In a market economy, buyers determine what should be produced by choosing what they want to buy. The number of people willing to buy a product determines its success or failure. Although buyers usually make their choices freely, government sometimes sets standards for products. This protects buyers from unsafe or overpriced products.

3. What two factors determine what is offered for sale in a market economy?
Profit Incentive (page 43)

When people invest their resources in a business, they do so in order to make a profit—the money left after all the costs of production have been paid. The desire for profit is called the profit incentive. This is what encourages entrepreneurs to start businesses or change the kinds of products they produce. Lack of profit causes business to move resources elsewhere. Therefore, profit is what keeps an economy efficient and adaptable to change.

4. What role does profit play in a market economy?

Private Property (page 43)

Private property is property that is held by individuals or groups instead of by government. It is one of the most important features of capitalism. People are free to buy whatever they can afford. They can also control how their property is used. Property rights are actually the rights to risk investment and to own productive assets in the hopes of making profits.

5. How are private property rights related to the system of capitalism?

Competition (page 44)

The lure of profits encourages competition—the rivalry among producers of similar products. A large amount of competition keeps prices down. If one company tries to raise its prices, buyers can go elsewhere. Competition leads to efficiency because sellers have to keep costs and prices low enough to attract buyers and make a profit. For competition to exist, the barriers to enter an industry must be weak. Existing companies must also be able to easily leave their old industry and begin making new products.

6. What effect does competition have on prices and why?
THE GOALS OF THE NATION

KEY TERMS

*economic efficiency*  Wise use of available resources so that costs are not greater than benefits (page 47)
*economic equity*  The attempt to balance an economic policy so that everyone benefits fairly (page 47)
*standard of living*  The material well-being of an individual, group, or nation measured by how well their needs and wants are satisfied (page 48)
*economic growth*  Expansion of the economy by producing more goods and services over the long term (page 48)

DRAWING FROM EXPERIENCE

One of the reasons you are in high school instead of working full-time or just “hanging out” is because you realize that your education is your investment in the future. You know that getting an education will benefit you economically by helping you get a better job and acquire more of the goods and services you want and need. But did you know that by being in school, you are helping to ensure the success of the nation’s economic system?

This section focuses on how the American free enterprise system illustrates the values and goals of the nation and its people.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Describe each of the nation’s economic goals in a short phrase. The first one has been done for you.

<table>
<thead>
<tr>
<th>Economic Goal</th>
<th>Short Description</th>
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<tbody>
<tr>
<td>Economic Freedom</td>
<td>ability to make decisions in the marketplace</td>
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<tr>
<td>Economic Efficiency</td>
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<tr>
<td>Economic Equity</td>
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<tr>
<td>Economic Security</td>
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<tr>
<td>Economic Stability</td>
<td></td>
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<tr>
<td>Economic Growth</td>
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</table>
READ TO LEARN

Introduction (page 46)

This section points out how the United States strives to meet its economic goal stated in the Constitution: “to promote the general Welfare.”

Goals of a Free Enterprise economy (page 46)

The United States has a capitalist, or free enterprise, economic system. The features of a market economy can be seen by looking at the nation’s goals in economic terms.

Economic Freedom This goal is that each member of society have the freedom to make decisions in the marketplace and other economic choices. However, this freedom also requires that people accept the results of their choices.

Economic Efficiency This goal is to use our limited resources wisely so that the costs of economic actions are not greater than their benefits. For example, at one time most Americans farmed. However, labor efficiency allows relatively few Americans today to grow the food for us all.

Economic Equity This goal is to have an economic system that is fair and just. To reach it, we have laws requiring fairness in hiring practices, minimum wage laws, and other laws.

Economic Security Our economic system often requires that we take economic risks. However, Americans want protection against risks that are beyond their control—for example, natural disasters and poverty in old age. So programs such as Social Security provide economic security.

Economic Stability This goal seeks to reduce the extreme ups and downs in the standard of living—people’s material well-being.

Economic Growth As the population increases, the economy must grow in order to provide for more wants and needs. Economic growth also helps the nation meet other goals.

Elected and appointed government officials make economic policies to obtain the nation’s goals. However, achieving them requires trade-offs. For example, any program that provides economic security uses resources that could have been used elsewhere. The scarcity of resources means that not all political desires can become economic reality.

1. How are the goals of economic freedom and economic security connected?

Balancing Economic Rights and Responsibilities (page 48)

The free enterprise system provides many economic rights. People have the right to engage in almost any economic activity that is legal. For example, they can choose their profession, business, or job. They have the right to buy only the products and brands that they like. However, for the system to continue functioning well, people have the responsibility to be productive members of that system, to elect responsible leaders to set economic policies, and to analyze the results of those policies. Central to all these responsibilities is the responsibility to get an education.

2. Why is education important to the success of a free enterprise system?
**CONSUMPTION, INCOME, AND DECISION MAKING**

**KEY TERMS**

- **consumer** Any person or group that buys or uses goods and services to satisfy personal needs and wants (page 59)
- **disposable income** Income remaining for a person to spend or save after all taxes have been paid (page 60)
- **discretionary income** Money income a person has left to spend on extras after necessities have been bought (page 60)
- **rational choice** Choosing the alternative that has the greatest value from among comparable quality products (page 62)

**DRAWING FROM EXPERIENCE**

Do you know where you can buy your favorite fashions? Are your favorite fashions the lowest in cost? Are there other clothes that might be a better value? Is the cost of the clothes the only factor that determines their value?

This section defines the role of a consumer and explains how consumers make purchasing decisions.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read through the summaries that follow. As you read, think about how you make purchasing decisions.
Each of us is a consumer because we all purchase goods and services to satisfy our needs and wants. We may purchase different goods, but we all take into consideration some of the same factors when we make purchasing decisions. We might ask ourselves, do I need this item, or do I just want it? Is it a good value? Can I afford it?

1. What is a consumer?

A person uses disposable income to pay for rent, food, and clothing, or other basic necessities. A person uses discretionary income to buy a luxury item or see a movie.

How much disposable and discretionary income a person has depends upon how much money he or she can earn. Statistics show that the more education a person has, the more income they are likely to earn. Also, a person’s occupation and health play a part in how much they can earn. A person’s discretionary income is dependent upon how much that person must pay for basic necessities, such as food and housing.

2. What is the difference between disposable income and discretionary income?

You make purchasing decisions every day. You might make some purchasing decisions with little thought. You might make other purchasing decisions with a lot of research and thought.

Here is a checklist for consumer decision making.

A. Deciding to spend your money Suppose you are thinking about purchasing a new mountain bike. Before you decide to buy one, you must ask yourself whether or not you really require it. You also might ask yourself if there is a better use for your income at this time.

B. Deciding on the right purchase Once you have decided to purchase a mountain bike, you need to decide which mountain bike is the right purchase for you. Do you want a high-, medium-, or low-quality bike? Is name brand important to you? Do you want to wait until the mountain bikes are on sale to purchase one? Should you purchase a used mountain bike? What kind of warranty comes with the bike and what sort of exchange or return policy does the store offer for the bike?
C. Deciding how to use your purchase

After you purchase your new mountain bike, you must decide how you will use and care for it. Will you make repairs yourself? How much can you spend on repairs? How long can you expect the mountain bike to last?

Suppose you narrow down your choices to two different mountain bikes. One bike costs $125 more than the other because it is made out of a lightweight material. As a consumer, you must decide whether the more expensive model is worth paying $125 more for it. When you decide which bike is a better value, you are making a rational choice. We say that people make rational choices when they decide to purchase the product or service that has the greatest perceived value. Rational choice involves choosing the best-quality item that is the least expensive from among comparable quality products.

3. How does a consumer make a rational choice?
KEY TERMS

**competitive advertising** Advertising that attempts to persuade consumers that a product is different from and superior to any other (page 68)

**informative advertising** Advertising that benefits consumers by giving information about a product (page 68)

**bait and switch** Deceptive advertising practice that attracts consumers with a low-priced product, then tries to sell them a higher-priced product (page 69)

**comparison shopping** Getting information on the types and prices of products available from different stores and companies (page 69)

**warranty** Promise made by a manufacturer or a seller to repair or replace a product within a certain time period if it is found to be faulty (page 70)

**brand name** Word, picture, or logo on a product that helps consumers distinguish it from similar products (page 70)

**generic brands** General name for a product rather than a specific brand name given by the manufacturer (page 70)

**DRAWING FROM EXPERIENCE**

Think about the last major item you purchased. How much information did you gather before deciding to purchase? Did advertisements give you plenty of information? Did you check different stores to get the best price? Was the warranty a factor in your decision?

This section explains how consumers make buying decisions to get the most satisfaction from their limited income and time.

**ORGANIZING YOUR THOUGHTS**

Use the following chart to help you take notes as you read the summaries that follow. As you read, think about what kind of advertising is the most helpful when making purchasing decisions.

<table>
<thead>
<tr>
<th>Gathering Information</th>
<th>The Three Principles of Buying</th>
<th>Comparison Shopping</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where can you get information about an item you wish to buy?</td>
<td>Using Advertising Wisely</td>
<td>What should you look for in comparison shopping?</td>
</tr>
<tr>
<td>1</td>
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</tbody>
</table>
READ TO LEARN

Introduction (page 66)

The goal of advertising is to win your consumer dollars. A consumer’s goal should be to obtain the most satisfaction from their resources of time and money. Consumers can achieve this goal by employing the following three principles of buying:

A. Gathering information
B. Using advertising wisely
C. Comparison shopping

1. What is the goal of advertising?

Gathering Information (page 66)

Suppose you are thinking about purchasing a portable CD player. You can get information about portable CD players from friends and family, the Internet, and salespeople. The amount of information you get depends upon how much time you spend researching the portable CD player. You must determine how much time to spend researching and how much information is necessary to make your decision.

2. Where can you find information about a product you want to buy?

Using Advertising Wisely (page 68)

As you gather information about portable CD players, you will see several types of advertising about them. Competitive advertising tries to convince you that a product is different or superior to another. Informative advertising gives you detailed information about a product. Bait and switch is an illegal form of advertising. The bait is advertising that lures you into a store for a discounted item. When you arrive at the store, a salesperson will inform you that there are no more items available at that cost. You are then directed to buy a similar item at a higher cost. This is the switch.

3. What is the difference between competitive advertising and informative advertising?
Comparison Shopping (page 69)

After gathering the information you need, get information on types and prices of products available from different stores or companies. This is called comparison shopping.

A warranty is a promise given by either the store or the manufacturer to replace or repair a product that is found to be faulty within a specific period of time. Consumers must also make the decision between a brand name product, a product that has an identifiable name or logo, or a generic brand product, a product that does not have a brand name.

4. What is comparison shopping?
**CONSUMERISM**

**KEY TERMS**

*consumerism* Movement to educate buyers about the purchases they make and to demand better and safer products from manufacturers *(page 72)*

*ethical behavior* Acting in accordance with moral and ethical convictions about right and wrong *(page 75)*

**DRAWING FROM EXPERIENCE**

Do you pay attention to warning and safety labels on products you use? Do you think companies should be responsible for the safety of their products and services? What actions could you take if you were injured or hurt by a product you purchased?

This section focuses on the rights and obligations of consumers and the obligations of manufacturers regarding the safety of products and services.

**ORGANIZING YOUR THOUGHTS**

Use this chart to help you take notes as you read the summaries that follow. As you read, think about how you might become a well-informed consumer.

<table>
<thead>
<tr>
<th>Help for Consumers</th>
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<tbody>
<tr>
<td><strong>Sources of consumer information</strong></td>
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<tr>
<td>1.</td>
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<td>3.</td>
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<tr>
<td><strong>Consumer rights stated by President Kennedy</strong></td>
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Many government and private groups have been formed to address the safety and reliability of the products consumers use. Consumerism is the name given to a movement that educates buyers about products and services and demands safer and more reliable products from manufacturers.

1. What issues does consumerism address?

Consumerism has been growing since the early 1960s. John F. Kennedy addressed consumer rights in a message to Congress in 1962. Here are the principles he outlined.

A. The right to safety—protection against goods and services that are dangerous.
B. The right to be informed—information for use not only as protection against fraud but also as the basis for reasoned choices.
C. The right to choose—the need for markets to be competitive or to be protected in markets where competition does not exist.
D. The right to be heard—guarantee that consumer interests will be considered when laws are written.

2. Why is Kennedy’s message to Congress important to consumers?

Based on President Kennedy’s message to Congress, laws were enacted so that consumers can either complain to a store or to a manufacturer. Consumers also can file a formal law suit against a store or manufacturer for a faulty or dangerous product or service.

Private and government consumer groups have been established to help consumers. Many private consumer groups provide information about reliable or faulty products and services. Some of these groups are the Better Business Bureau, Consumers’ Research, Inc., and the Consumers Union of the United States, Inc., which publishes a magazine called Consumer Reports. Many government agencies also offer programs that insure consumer rights are protected, such as the Federal Trade Commission, the Food and Drug Administration, and the National Highway Traffic Safety Administration.
3. What can a consumer do if they have purchased a faulty or unsafe product or service?

   • Consumer Responsibilities (page 73)

   Consumers have a responsibility to try to be informed about products or services they wish to purchase. If a consumer finds they have purchased a faulty product, it is the consumer’s responsibility to take the first step in addressing the problem. The Bureau of Consumer Protection suggests that consumers do the following:

   A. Report the problem immediately.
   B. State the problem and suggest a fair and just solution—replacement, refund, etc.
   C. Include important details and copies of receipts and warranties.
   D. Describe any action taken to try to correct the problem.
   E. Keep an accurate record of efforts to solve the problem.
   F. Allow each person reasonable time to solve the problem before contacting another person.
   G. When contacting the manufacturer in writing, type a letter or send an E-mail directly. Keep copies of any letters sent.
   H. Keep cool. The person who will help solve the problem is probably not responsible for the problem.

   A consumer’s actions should always be governed by a principle of ethical behavior. Ethical behavior involves acting on one’s own moral convictions about what is right and wrong. For example, a consumer should not try to return an item just because he or she found it at a lower price somewhere else.

4. What responsibilities do you have as a consumer if you find you have purchased a faulty product or service?
AMERICANS AND CREDIT

KEY TERMS

credit Receipt of money either directly or indirectly to buy goods and services in the present with the promise to pay for them in the future (page 83)
principal Amount of money originally borrowed in a loan (page 84)
interest Amount of money the borrower must pay for the use of someone else's money (page 84)
installment debt Type of loan repaid with equal payments, or installments, over a specific period of time (page 84)
durable goods Manufactured items that have a life span longer than three years (page 84)

DRAWING FROM EXPERIENCE

Are you saving money to buy an item such as a stereo or a computer? How long will it take you to save the money you need? Suppose you did not have enough money to pay for the item right away. Would you be willing to give up some future earnings for the item if you could have it now?

This section explains how credit works, how Americans use credit and borrow money, and what can happen if you do not use credit wisely.

ORGANIZING YOUR THOUGHTS

Use this chart to help you take notes as you read the summaries that follow. As you read, consider what items would be appropriate to buy using credit.

<table>
<thead>
<tr>
<th>What is Credit?</th>
<th>What items do people buy using credit?</th>
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</thead>
<tbody>
<tr>
<td>Credit is</td>
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<tr>
<td>Principal is</td>
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<tr>
<td>Interest is</td>
<td></td>
</tr>
<tr>
<td>Installment debt is</td>
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READ TO LEARN

What Is Credit? (page 83)

Our nation's economy depends upon the ability of people and organizations to borrow money. Individuals, companies, and governments use credit, or receive funds to buy goods and services with the promise to pay for them in the future. A person might buy a car using credit. When a person uses credit to buy a car, the money that covers the cost of the car is called the principal. When paying back the money, he or she also pays interest, or the fee for using someone else's money to buy the car.

1. What is credit?

Installment Debt (page 84)

When a person buys a car using credit, the person has an installment debt. The debt is paid back in monthly installments. Most people buy durable goods on an installment plan. Durable goods are manufactured items that are built to last more than three years, such as cars, refrigerators, and washing machines.

The largest form of installment debt in the United States is the money people owe on mortgages. A mortgage is an installment debt that people owe on land, houses, or buildings. Most mortgages are paid in installments spread over 15 to 30 years.

The length of an installment plan is important because the longer the installment plan, the more interest a person pays. A person can have a lower monthly payment if the person's mortgage is paid over 30 years instead of 15. However, the person will pay more interest.

2. What is an installment debt?
People use credit for a variety of reasons. For instance, a person might want to buy a new car. The person knows he or she can save the necessary money, but it will take three years to do so. If the person borrows money and buys on an installment plan, then he or she can drive the car right now. Another reason people use credit is that some people would rather spread the payments for the car over the life of the car.

3. Why do some people use credit?

The only way to decide to use credit is to figure out whether the interest charged is worth the satisfaction received from the purchase. The benefit of borrowing is having the good or service now instead of later. The trade-off is spending more money in the form of interest to have that good or service immediately. Interest is money you could spend on other items. Only the consumer can decide whether the trade-off is worthwhile.

Many Americans buy too many goods and services using credit and do not consider the interest they will have to pay. Remember that credit card companies, stores, and banks make money by lending money. Just because someone offers a person credit does not mean he or she should accept it.

4. What should a person consider before using credit to purchase a good or service?
Sources of Loans and Credit

Key Terms

commercial bank  Bank whose main functions are to accept deposits, lend money, and transfer funds among banks, individuals, and businesses (page 89)
savings and loan association (S&L)  Depository institution that accepts deposits and lends money (page 89)
savings bank  Depository institution originally set up to serve small savers overlooked by commercial banks (page 89)
credit union  Depository institution owned and operated by its members to provide savings accounts and low-interest loans only to its members (page 89)
finance company  Company that takes over contracts for installment debts from stores and adds a fee for collecting the debt; consumer finance company makes loans directly to consumers at high rates of interest (page 90)
charge account  Credit extended to a consumer allowing the consumer to buy goods or services from a particular company and to pay for them later (page 90)
credit card  Credit device that allows a person to make purchases at many kinds of stores, restaurants, and other businesses without paying cash (page 91)
finance charge  Cost of credit expressed monthly in dollars and cents (page 92)
annual percentage rate (APR)  Cost of credit expressed as a yearly percentage (page 92)

Drawing from Experience

Does your family use a bank? Do you use the bank to help save money? Does your family borrow money from that institution to help pay for large items such as appliances or cars?

This section outlines the different kinds of institutions that loan money and extend credit. It also explains interest rates on those funds.

Organizing Your Thoughts

Use this chart to help you take notes as you read the summaries that follow. As you read, be sure to pay close attention to the different types of lending institutions.

<table>
<thead>
<tr>
<th>Type of lending institution</th>
<th>Description</th>
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There are two major ways of obtaining credit—credit cards and loans. Credit purchases obligate you to pay interest.

Commercial banks loan large amounts of money and offer a wide range of services. A person can use a commercial bank to open a checking or savings accounts, as well as to borrow money. Savings and loan associations (S&Ls) were originally formed as “building societies” where members would combine their money and take turns using it to build homes until each member had a home. Today, S&Ls also offer checking and savings account services. Like S&Ls, savings banks lend money for home mortgages and some personal and auto loans. Since 1980, S&Ls also have been able to offer commercial banking services such as checking accounts.

Some companies offer their employees the option of becoming members of a credit union. Credit unions are owned by their members and provide savings accounts and low-interest loans to their members only.

If a person has a store credit card, a finance company is probably in charge of collecting the debt. Finance companies contract with retail stores to collect the store’s installment debts. A consumer finance company lends money at higher interest rates than most institutions. This company usually lends to people who have had trouble repaying loans in the past or who have had uneven employment records.

1. What types of lending institutions also offer commercial banking services?

Charge Accounts

Department stores offer customers charge accounts so that customers can charge goods without borrowing the money. There are three types of charge accounts. With a regular charge account, the customer must pay the entire amount due. If the person does not pay the entire amount, then interest is added and he or she is not able to use the account again until it is paid. A revolving charge account allows customers to pay a portion of the amount due and pay interest on any unpaid amount. Some stores offer installment charge accounts for larger items such as televisions and refrigerators. In this case, the customer makes equal payments that are spread over a period of time. Those payments include interest.
2. What are the three kinds of charge accounts?

[Blank]

Credit Cards (page 91)

Credit cards allow customers to purchase goods without paying cash. Unlike charge accounts, credit cards can be used at many different stores, restaurants, hotels, and other businesses. Credit cards also allow customers to borrow money up to a certain limit. The interest rates on credit cards are typically high.

3. What is the difference between a credit card and a charge account?

[Blank]

Finance Charges and Annual Percentage Rates (page 92)

The cost for using a store credit card or charge account is expressed on a monthly bill in two ways: finance charges and an annual percentage rate. Finance charges tell the cost of credit in terms of dollars and cents. The annual percentage rate (APR) tells the cost of credit as a yearly percentage of the amount of the loan.

Finance charges are usually computed monthly. They reflect both the interest rate being charged and any other charges, such as an annual membership fee. Annual percentage rates also reflect both the interest rate paid and any other charges. However, this rate gives a simple yearly percentage instead of a monthly dollar amount. When a person is shopping for a credit card, the annual percentage rate will help him or her determine which company is offering a better deal. The lower the annual percentage rate is, the lower the cost of using that credit card will be.

4. What is the difference between finance charges and annual percentage rates?

[Blank]

Debit Cards (page 94)

Another method of payment for which a person does not need cash is the use of a debit card. Debit cards do not provide loans, but they do allow for direct payment from a bank account to the store where the purchase is being made. Because the money comes directly from a bank account, a person does not pay interest or any other finance charges for using a debit card.

5. How is a debit card different from a credit card or charge account?

[Blank]
A P P L Y I N G  F O R  C R E D I T

KEY TERMS

credit bureau  Private business that investigates a person to determine the risk involved in lending money to that person (page 96)
credit check  Investigation of a person’s income, current debts, personal life, and past history of borrowing and repaying debts (page 96)
credit rating  Rating of the risk involved in lending money to a specific person or business (page 97)
collateral  Something of value that a borrower lets the lender claim if a loan is not repaid (page 98)
secured loan  Loan that is backed up by collateral (page 98)
unsecured loan  Loan guaranteed only by a promise to repay it (page 98)

D R A W I N G  F R O M  E X P E R I E N C E

How can you obtain credit? How do lending institutions decide who is creditworthy and who is not? Are there actions you can take to make sure you will be a responsible borrower?

This section explains what happens when a person applies for credit. It also focuses on the responsibilities of borrowers once they have secured credit or a loan.

O R G A N I Z I N G  Y O U R  T H O U G H T S

Use this chart to help you take notes as you read the summaries that follow. As you read, think about how you can be considered creditworthy by lending institutions and credit card companies.
READ TO LEARN

Introduction (page 96)

How can you obtain credit? What makes a person a good credit risk?

Creditworthiness (page 96)

After you apply for credit, the lending agency, bank, or store to which you applied hires a credit bureau to do a credit check. The results of the credit check determine your creditworthiness. A credit check examines a person’s income level, current debts, and record of repaying debts in the past.

1. What is a credit check?

The Credit Rating (page 97)

After the credit check has been done, the lending institution gives you a credit rating. This credit rating indicates whether you are a good, average, or poor credit risk. There are several factors that help the lending institution make this determination.

First, they look at your capacity to pay. Your capacity to pay is dependent upon your income level and employment history. They also consider how much debt you currently have.

Also, lending institutions will consider your reputation as a reliable and trustworthy person. They may look at your work in the community or in school, your educational background, and whether or not you have had problems with the law.

They also might consider collateral when determining if you are creditworthy. Your collateral is your personal wealth or capital. A lending institution might be more likely to lend you money if they think you have something of value that can be sold if you have financial difficulty.

If the lending institution decides to loan money, there are two kinds of loans. A secured loan is one where the lending institution retains ownership of something the borrower has, such as a car or other valuable. That item can then be sold if the borrower does not repay the loan. If the borrower is a very good credit risk, he or she might be awarded an unsecured loan. This loan is not guaranteed by anything but the promise to repay it.

2. How does a lending institution determine your creditworthiness?
Your Responsibilities As a Borrower (page 98)

Lending institutions and credit card companies want to lend money or give credit to responsible borrowers. There are two simple things you can do to be a responsible borrower.

Paying on time is the most important responsibility. If you do not pay on time, the company incurs costs in mailing you reminders and hiring people to collect the money you owe. Eventually, the company will pass these costs along to you in the form of higher interest rates. You also have an obligation to keep good records. Keep records of all your purchases and payments. This will help you make sure you do not go over your credit limit.

If you have borrowed more money than your income can pay back, or if you have made too many charges on too many credit cards, you can lose control of your debt. The danger of losing control of your debt is that it might take years to repay it. In addition, you might not be able to meet other personal goals, such as owning a home or a car, because of your uncontrollable debt.

If this happens to you, financial planners advise you to make a list of everything you owe, including the amount of interest. Always pay debt that is at the highest interest rate first. Always pay more than the monthly minimum, or it will take years to reduce your debt.

3. What are your responsibilities as a borrower?
KEY TERMS

**usury law**  Law restricting the amount of interest that can be charged for credit (page 102)

**bankruptcy**  The inability to pay debts based on the income received (page 104)

**DRAWING FROM EXPERIENCE**

Should a credit card company be able to set their interest rates as high as they want? How would you feel if you were turned down for a credit card just because of your religion or gender?

This section explains how government regulations have tried to guarantee fairness and equity in credit practices. It also explains what a consumer can do if his or her debt becomes too great.

**ORGANIZING YOUR THOUGHTS**

Use this chart to help you take notes as you read the summaries that follow. As you read, think about what you can do to protect yourself from acquiring too much debt.

Federal and State Regulations on Credit Practices

<table>
<thead>
<tr>
<th>Name or type of regulation</th>
<th>How the law or act protects consumers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
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<tr>
<td>2.</td>
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<tr>
<td>3.</td>
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</tbody>
</table>

**READ TO LEARN**

- **Introduction**  (page 101)

- **The Truth in Lending Act**  (page 102)

The Truth in Lending Act is a federal law enacted in 1968 to protect consumers from unfair credit practices. This law states that creditors must inform borrowers in writing of annual percentage rate, the way in which charges and fees are calculated, and the payment schedule. It grants consumers a three-day cooling-off period in which they can cancel certain contracts. It also makes consumers liable for only the first $50 of unauthorized purchases made on credit cards before the card is reported lost or stolen.
1. What is the Truth in Lending Act of 1968?

2. How does the Equal Credit Opportunity Act guarantee fairness?

3. What are usury laws?

4. Why would a person file personal bankruptcy?
Study Guide
Chapter 5, Section 1
For use with textbook pages 111–115

SHOPPING FOR FOOD

KEY TERMS

- **club warehouse store** Store that carries a limited number of brands and items in large quantities; less expensive than supermarkets (page 112)
- **convenience store** Store open 16 to 24 hours a day, carrying a limited selection of relatively higher-priced items (page 113)
- **private-labeled products** Lower-priced store-brand products carried by some supermarket chains and club warehouse chains (page 113)

DRAWING FROM EXPERIENCE

Do you help with the grocery shopping for your home? Does your family clip coupons to save money on food and other household items? What is the best place to save money when shopping for food? Where can you find the best selection of items?

This section focuses on the different places people shop for food. It also explains how people compare the value of one store with another.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about why consumers use different kinds of stores when shopping for food.

Comparison Shopping Checklist

<table>
<thead>
<tr>
<th>Trade-Offs in Different Stores</th>
<th>How to Get the Most from Your Money</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of Store</strong></td>
<td><strong>Trade-Offs</strong></td>
</tr>
<tr>
<td>supermarket</td>
<td></td>
</tr>
<tr>
<td>club warehouse</td>
<td></td>
</tr>
<tr>
<td>convenience store</td>
<td></td>
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</tbody>
</table>
Thousands of different food products are available in thousands of different stores. Americans need to learn how to get the most for their food dollars.

Americans use comparison shopping to help them decide where to shop for food. Comparison shopping also helps them decide what brands and sizes to buy. Comparison shopping helps consumers determine the best value for their time and money. Using time wisely is one of the keys to effective comparison shopping. Reading advertisements, rather than traveling to several stores, is an inexpensive way to save time while comparison shopping.

Ways to get the most from your money when food shopping:

A. Read newspapers for sales and cents-off coupons.
B. Make a shopping list and use coupons. Plan a week’s worth of meals so that you buy only what you need.
C. Avoid impulsive buying, or buying without thinking about the purchase beforehand.
D. Buy nutritional items first. Check labels for nutritional value.
E. Check freshness dates.
F. Compare prices on private-labeled products, generic products, and national brands.
G. Check unit prices. Do not buy large quantities unless you will use them quickly or can store them easily.
H. Do not shop when you are hungry or thirsty. You will be tempted to buy more food than you need.

1. Name four ways you can get the most from your money when food shopping.

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________
Most Americans do their food shopping in large supermarkets or in club warehouse stores. **Club warehouse stores**, such as Costco, sell food at lower prices and in larger quantities than most supermarkets. One trade-off in buying from a club warehouse store is that you spend more money for the larger quantity of the item. Another trade-off is that you need room to store more items in your home. However, by buying larger quantities you save time because you will not have to return to the store as often. You also might save money in the cost per item.

Another choice in food shopping is the convenience store. **Convenience stores**, such as 7-Eleven, sell a very limited selection of food items. People often shop at convenience stores because they save time. The trade-off in shopping at a convenience store is that convenience stores charge more for most food items.

Consumers must decide whether to purchase name-brand products, private-labeled products, or generic products. **Private-labeled products**, or store brands, are often less expensive than name-brand products. Also, consumers can save money by buying generic products, or products with no brand name.

There can be a trade-off between quality and price in products you buy. For example, a less expensive, store-brand American cheese might not melt as smoothly as Velveeta American cheese. Items sold in large quantities often sell at a lower per-unit price than those in smaller quantities. This means that a gallon of milk usually costs less per ounce than a quart of milk.

Consumers can take advantage of cents-off coupons. A cents-off coupon offers a discount on a specific brand and size of a product. A consumer must decide if the coupon discounts are worth the time spent searching for the coupon and finding the specific item when shopping. If a coupon is for an item the consumer usually does not buy, the coupon might not be worth the savings.

2. What are the trade-offs involved in shopping at club warehouse stores rather than at supermarkets?
Clothing Choices

Key Terms

durability Ability of an item to last a long time (page 118)

service flow Amount of use a person gets from an item over time and the value a person places on this use (page 118)

Drawing from Experience

Do you shop for your own clothes? If so, do you try to shop when there are sales at your favorite stores? How do you decide which item to buy? How do you decide what clothes are the best value? This section focuses on how consumers can get the most from their money when shopping for clothes. It also explains how consumers determine the value of the clothing they purchase.

Organizing Your Thoughts

Use the diagram below to help you take notes as you read through the summaries that follow. Think about what you can do to help your family or household get more for its money when shopping for clothes.

<table>
<thead>
<tr>
<th>Determining the Value of Clothing</th>
<th>Determining Your Clothing Wants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1.</td>
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<td>2.</td>
<td>2.</td>
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<td>3.</td>
<td>3.</td>
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<tr>
<td>4.</td>
<td>5.</td>
</tr>
</tbody>
</table>

Read to Learn

- Introduction (page 117)

For Americans, variety, more than durability, is the motivating factor in clothing choice.

- Comparing Clothing Value (page 117)

Three factors should be considered when determining the value of clothing.
A. **Style** Wearing current styles usually means a person will have to spend money on new clothes each year when styles change. Consumers can save money by wearing classic styles, or clothing styles that can be worn year after year.

B. **Durability** The longer a piece of clothing lasts, the more durable it is. Suppose you buy a shirt that costs $60 and it lasts two years. The annual *service flow* of that shirt is $30. Suppose you buy a less expensive but poorly made shirt for $40. The shirt lasts only one year. The annual service flow of that shirt is $40. In this case, the less expensive shirt is not as good a value as the more expensive shirt.

C. **Cost of Care** A person must consider the cost of caring for clothing when shopping for clothes. For instance, dry-cleaning is more expensive than hand or machine washing.

1. What are the three factors in determining clothing value?

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**More for Less** *(page 119)*

Clothing costs are lower today than they were 70 years ago. Seventy years ago, a good suit with a price tag of $40 cost a person two weeks’ salary. Today, a good suit might have a price tag of $500, but it costs the average working person only one week’s salary.

Wise consumers try to get more for their money by purchasing clothing that is on sale. Stores often put clothing on sale that they were unable to sell during the regular selling season. For example, suppose you purchased summer clothes on sale at the end of the summer. If the clothes are good quality, they will last through next summer and more.

Some consumers become bargain fanatics, willing to purchase anything as long as it is on sale. Making shopping lists before a shopping trip can help prevent unnecessary purchases. Consumers can use the following guidelines for determining their clothing wants.

A. What do I already have? Clothes that are durable do not need to be replaced as often.

B. What clothes do I wish to have for school? For my job? For my social life and recreational activities?

C. How many changes of clothes do I require to meet my minimum standards for cleanliness, variety, and social status?

D. How do my answers to questions A through C compare with the amount of income I have to spend?

E. Should I pay cash or charge my purchases? Consider the trade-offs involved in paying cash or using credit.

2. How can wise consumers get more for their money when buying clothing?
**KEY TERMS**

*closing costs* Fees involved in arranging for a mortgage or in transferring ownership of property (page 123)

*points* Fees paid to a lender and computed as percentage points of a loan (page 123)

*lease* Long-term agreement describing the terms under which property is rented (page 124)

*security deposit* Money a renter lets an owner hold in case the rent is not paid or an apartment is damaged (page 125)

**DRAWING FROM EXPERIENCE**

Does your family own a home, or do they rent an apartment or condominium? Have you thought about someday owning a home of your own?

This section explains the advantages and disadvantages of owning a home and renting one. It also explains what is involved in buying a home or renting an apartment.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read through the summaries that follow. Think about what it takes to be a responsible renter or homeowner. If you rented an apartment, would you be prepared to be a responsible renter?

<table>
<thead>
<tr>
<th>Owning a Home</th>
<th>Renting an Apartment or Condominium</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
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<td></td>
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</table>
READ TO LEARN

**Introduction** (page 121)

There are advantages to owning a home. Homeowners can remodel their home however they choose. Renters cannot remodel or even paint their property without the owner's permission. Owning a home is usually a good investment that increases in value. Renters do not get any return on their rental money. A renter will never own the property regardless of how much he or she pays, and therefore cannot sell the property for a profit. Homeowners get a significant income tax benefit for owning a home. Renters get no tax benefits.

Nonetheless, there are advantages to renting as well. Renters have greater mobility. They can move to a smaller or larger property without worrying about selling their property. Renters do not pay maintenance costs, real estate taxes, or depreciation costs that homeowners do. Renters only pay a small security deposit in costs up front. Buying a home requires a lot of money up front for a down payment. Renters usually have lower monthly payments than do homeowners.

1. What are some of the advantages of renting?

**How Much Should You Spend?** (page 121)

Obtaining financing is the most difficult part of buying a home. People buying homes usually obtain a large loan to pay for the home called a mortgage. A mortgage usually requires making a down payment. If a person is buying a home for $100,000 and he or she makes a down payment of $20,000, the person must obtain a mortgage for the remaining $80,000. The home buyer pays back the mortgage in monthly installments that include interest.

When a person arranges to take out a mortgage to buy a home, he or she also may pay points. Points are additional costs paid to the mortgage lender. These points are expressed as a percentage of the entire mortgage. If a mortgage is for $80,000 and the mortgage lender is adding one point, then the home buyer must pay an additional one percent of $80,000, or $800.

Besides the cash down payment and the points, there are other costs in buying a home called closing costs. Closing costs include the costs of any taxes, legal filings, loan applications, house inspections, and title searches. The person buying the house usually pays these fees.

2. Besides the cash down payment, what other costs are involved in buying a home?
If a person rents an apartment, house, or condominium, he or she is asked to sign a lease. The lease, or contract, will contain several clauses. One of these clauses will state the term of the lease, which is usually one to three years. Renters, or tenants, are guaranteed certain rights in the lease. For instance, tenants have the right to use the property for the purpose stated in the lease. Tenants also have the right to privacy. A lease usually states that the landlord cannot enter the tenant’s apartment except for necessary repairs or to show the apartment to a potential renter.

Tenants also have responsibilities. Tenants must pay the rent on time and take care of the property. If major repairs are needed, it is the tenant’s responsibility to tell the landlord. Most leases also require the tenant to give the landlord a security deposit. The landlord holds this money, which is usually equal to a month’s rent, in case there is damage to the apartment when the renter vacates it. Also, most leases state that the tenant must give notice, or a formal warning, if he or she plans to move out of the apartment before the term of the lease is over.

In most states, landlords have the responsibility of making sure their apartments provide certain services, such as heat and water, and that they are fit to live in. Most states also require landlords to provide certain safety features, such as smoke alarms and fire escapes. Leases usually state that the landlord must make repairs in a reasonable amount of time. Many states give renters the option of paying for repairs themselves if the landlord fails to do so. Then the renter can deduct the amount of the repairs from the rent payment.

In some cities, government officials have passed rent-control laws. These laws place a ceiling on the amount of rent a landlord can charge.

3. What are the rights and responsibilities of the tenant?

_________________________________________________________________

_________________________________________________________________

_________________________________________________________________
BUYING AND OPERATING A VEHICLE

KEY TERMS

registration fee  Licensing fee, usually annual, paid to a state for the right to use a car (page 130)

liability insurance  Insurance that pays for bodily injury and property damage (page 133)

DRAWING FROM EXPERIENCE

Are you thinking about buying a car? Are you aware of all of the costs involved in buying and operating a car?

This section explains the costs of buying, operating, and maintaining a new or used car.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the financial responsibilities connected with buying and operating a car.

<table>
<thead>
<tr>
<th>Costs of Buying an Automobile</th>
<th>Costs of Operating an Automobile</th>
</tr>
</thead>
<tbody>
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READ TO LEARN

Introduction (page 129)

Three of the major trade-offs involved in buying a new or used car include the following:

A. Usually, the smaller the engine, the less gas the automobile burns. Cars with smaller engines will cost less to operate. The trade-off is that a smaller engine might not accelerate as quickly as a larger one.

B. Newer cars cost more, but they usually require less maintenance.

C. Smaller automobiles are easier to park and turn, but larger automobiles usually offer better protection for their passengers in case of an accident.
1. What are some of the trade-offs in buying a smaller car?

**Buying and Operating a Vehicle (page 130)**

Most people borrow money to buy a car. Costs of a loan include the down payment, monthly payments on the principal, and interest. A person also can pay cash for a car. The trade-off is that they will not be able to purchase other things with the money used for the car.

Things to consider when buying a new or used car include the following:

A. Ask friends and relatives about their cars and how they like them.

B. Read articles about different makes and models of cars. Read *Consumer Reports* and *Consumers’ Research Magazine* for reviews on different cars. These magazines will give you information on repair records for different models.

C. Visit dealers and read brochures, but remember that these brochures only highlight the good points about a car.

D. Inspect several makes and models in different dealer showrooms.

E. Compare service warranties. Some used cars are still covered by their service warranties. Some used car dealers offer warranties for used cars.

F. Compare prices offered by several dealers.

G. If you are buying a used car, take the car to a certified mechanic.

H. Make sure federal excise taxes and dealer preparation charges are included in the list price. State and local taxes usually are added to the total cost later.

The registration fee is the licensing fee a state charges in order for a person to use a car. These fees are usually paid annually. Registration fees vary from state to state.

All cars require normal maintenance. Some cars require major repairs. Oil changes and minor tune-ups are considered normal maintenance. Rebuilding a transmission is considered a major repair. Check the repair records of different cars before deciding what make and model to buy.

Some dealers offer extended warranties to include normal maintenance or to extend the standard warranty over a longer period of time. Some dealers offer warranties on used cars.

All durable goods deteriorate, or lose value over time. This is called depreciation. Cars depreciate, or lose their value, every year, even if they are not driven.

Another major expense in operating a car is insurance. Most states require car owners to purchase *liability insurance* to pay for bodily injury and property damage if the car is involved in an accident. People under age 25 pay more for insurance because statistics show that people under age 25 are more likely to be involved in car accidents. Also, insurance companies charge higher rates for people who drive their cars in large cities. Insurance companies also consider the safety record of the type of car in determining the insurance rate.

2. What are the costs involved in buying and operating an automobile?
KEY TERMS

saving  Setting aside income for a period of time so that it can be used later (page 141)
interest  Payment people receive when they lend money or allow someone else to use their money (page 142)
passbook savings account  Account for which a depositor receives a booklet in which deposits, withdrawals, and interest are recorded (page 142)
statement savings account  Account similar to a passbook savings account except that instead of a passbook, the depositor receives a monthly statement showing all transactions (page 142)
money market deposit account  Account that pays relatively high rates of interest, requires a minimum balance, and allows immediate access to money (page 143)
time deposits  Savings plans that require savers to leave their money on deposit for certain periods of time (page 143)
maturity  Period of time at the end of which time deposits will pay a stated rate of interest (page 143)
certificates of deposit  Time deposits that state the amount of the deposit, maturity, and rate of interest being paid (page 143)

DRAWING FROM EXPERIENCE

Have you ever saved money to buy a specific item? Do you have a savings account? If so, do you know the rate of interest you earn on your savings?

This section focuses on the concept of saving money. It explains the different types of savings accounts available.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the differences among savings accounts as well as the advantages and disadvantages of each account.

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. passbook savings account</td>
<td></td>
</tr>
<tr>
<td>2. statement savings account</td>
<td></td>
</tr>
<tr>
<td>3. money market deposit account</td>
<td></td>
</tr>
<tr>
<td>4. time deposit or CD</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

[Introduction (page 141)]

Your savings goals will change as you move through life, but saving is always important to you and to the economy as a whole.

[Deciding to Save (page 141)]

If you are saving money toward a special item such as a mountain bike, you probably put your money in a savings account. If you do, you are helping the economy. It provides money for businesses to expand and increase income for consumers.

You earn interest on money you have in a savings account. Interest is payment you receive when you lend money or allow someone else to use your money. Several types of institutions offer savings accounts to individuals. Among these are commercial banks, savings and loan associations, savings banks, and credit unions. Wise consumers use comparison shopping to compare interest rates offered at the different institutions.

1. How does saving money in a savings account help the economy?

[Savings Accounts (page 142)]

With a passbook savings account, you receive a booklet in which deposits, withdrawals, and interest are recorded. You must present the booklet each time you make a deposit or withdrawal.

With a statement savings account, you are provided with a monthly statement. This statement shows the deposits, withdrawals, and interest earned over the course of one month. Usually, you can withdraw money at any time from this account. The interest paid on this account is low compared to other savings accounts.

A money market deposit account (MMDA) pays a higher interest rate than the two accounts mentioned above. The trade-off is that there is a minimum balance requirement of $1,000 to $2,500. Withdrawals can be made at any time. Also, a limited number of checks can be written from the account each month.

2. What is the difference between a passbook savings account and a statement savings account?
Time deposits are often called certificates of deposit (CDs). Time deposits, or CDs, offer higher interest rates than passbook or statement savings accounts, but there is a trade-off. These accounts require the depositor to leave his or her money in the account for a certain period of time. That period of time is called maturity. The maturity could be anywhere from three months to two years. Also, these accounts can have a minimum deposit. The minimum deposit can range from $250 to $100,000. CDs state the amount of the deposit, the maturity, and the rate of interest being paid.

These savings plans are considered low-risk, safe ways to save money. After the stock market crash in 1929, a federal law was passed that created the Federal Deposit Insurance Corporation. Today, several federal agencies insure most banks and savings institutions in the United States. These agencies insure individual deposits up to $100,000. This means that if your bank unexpectedly fails, each of your accounts is insured up to $100,000.

3. What is a time deposit, or CD?
Investing: Taking Risks with Your Savings

**KEY TERMS**

**stockholders** People who have invested in a corporation and own some of its stock (page 147)

**capital gain** Increase in value of an asset from the time it was bought to the time it was sold (page 147)

**capital loss** Decrease in value of an asset or bond from the time it was bought to the time it was sold (page 147)

**tax-exempt bonds** Bonds sold by local and state governments; interest paid on the bond is not taxed by the federal government (page 148)

**savings bonds** Bonds issued by the federal government as a way of borrowing money; they are purchased at half the face value and increase every 6 months until full face value is reached (page 149)

**Treasury bills** Certificates issued by the U.S. Treasury in exchange for a minimum amount of $1,000 and maturing in 3 months to 1 year (page 149)

**Treasury notes** Certificates issued by the U.S. Treasury in exchange for minimum amounts of $1,000 and maturing in 1 to 10 years (page 149)

**Treasury bonds** Certificates issued by the U.S. Treasury in exchange for minimum amounts of $1,000 and maturing in 10 or more years (page 149)

**broker** Person who acts as a go-between for buyers and sellers of stocks and bonds (page 149)

**over-the-counter market** Electronic purchase and sale of stocks and bonds, often of smaller companies, which takes place outside the organized stock exchanges (page 150)

**mutual fund** Investment company that pools the money of many individuals to buy stocks, bonds, or other investments (page 151)

**money market fund** Type of mutual fund that uses investors’ money to make short-term loans to businesses and banks (page 152)
DRAWING FROM EXPERIENCE

Did you know that savings accounts are not the only way to earn money on your savings? People can also earn money by investing their savings in stocks and bonds. Or, they might earn money on their savings by buying mutual funds.

This section focuses on the kinds of investment options that are available. It explains what stocks and bonds are and where to buy them.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about how different kinds of savings investments involve different levels of risk.

```
Investor Savings Plans

Stocks        Bonds        Mutual Funds
```

READ TO LEARN

Stocks and Bonds (page 146)

Savings plans offer one way for people to make money on their savings. Purchasing stocks and bonds is another way people can make money on their savings. Stocks and bonds can be more profitable than savings plans, but there is a trade-off. People who invest in stocks and bonds run a higher risk of losing their money.

A corporation sells shares of stock in order to obtain funds for expanding its business. In return, the buyer of the stock gets a certain portion of the future profits and assets of the corporation. A stockholder is then a part-owner of the corporation. A stockholder makes money through dividends, the money return on the amount the stockholder originally invested. Dividends are paid when the corporation makes a profit. Stockholders also can make money by selling their stock for more money than they paid for it.

When a stockholder sells stock and makes a profit, the profit is called a capital gain. If a stockholder sells stock at a lower price than he or she paid for it, it is called a capital loss.

Like stocks, bonds are investments. A bond is a certificate issued by a company or a government in exchange for borrowed money. Unlike stockholders, a bondholder does not own a share of the company or government that issued the bond. A bondholder lends money for a specific period of time with the promise that a certain amount of interest will be paid at the end of the specified time period.
Local and state governments can also offer tax-exempt bonds, or bonds that are not taxed by the federal government. The interest gained on these bonds is not taxed. Wealthy people invest in tax-exempt bonds to avoid paying taxes on large amounts of interest earned.

The United States government issues savings bonds as a way for the government to borrow. Savings bonds are similar to CDs. They are considered a very safe form of investment. A person purchases a savings bond at half its face value. If it is a $50 savings bond, the person pays $25 for it. The bond increases in value every 6 months until its full face value is reached.

Treasury bills, Treasury notes, and Treasury bonds are sold by the U.S. Treasury Department. These bonds are for larger investments. The minimum investment for a Treasury bill is $1,000, and it matures in 3 months to 1 year. The minimum investment for a Treasury note is $1,000, and it matures in 1 to 10 years. The minimum investment for a Treasury bond is $1,000, and it matures in 10 or more years. The interest earned on Treasury bills, notes, and bonds is exempt from state and local income taxes, but not from federal income tax.

1. What is the difference between a stock and a bond?
An index is a measuring system that tracks stock prices over a long period of time. A mutual fund broker will use an index as a guideline for choosing stock that will perform well over a long period of time. The most commonly used indexes are the Dow Jones Industrial Average (DJIA) and the Standard & Poor’s (S&P). The DJIA tracks the stock prices of 30 of the largest companies in America. The S&P tracks the stock prices of 500 companies. The S&P is the most widely used index.

Money market funds are mutual funds in which an investor earns interest on the money in the fund. The money market fund uses the investor’s money to buy the short-term debt of businesses and banks. Investors are able to write checks against the money in their money market fund. These funds are similar to money market deposit accounts (MMDA) offered by banking institutions. But unlike MMDA accounts, they are not insured by the federal government.

2. Where are most stocks and bonds traded?

3. What does the Securities Exchange Act require?
**KEY TERMS**

- **pension plans** Company plans that provide retirement income for their workers (page 155)
- **Keogh Plan** Retirement plan that allows self-employed individuals to save a maximum of 15 percent of their income up to a specified amount each year, and to deduct that amount from their yearly taxable income (page 156)
- **individual retirement account (IRA)** Private retirement plan that allows individuals or married couples to save a certain amount of untaxed earnings per year with the interest being tax-deferred (page 156)
- **Roth IRA** Private retirement plan that taxes income before it is saved, but which does not tax interest on that income when funds are used upon retirement (page 156)
- **diversification** Spreading of investments among several different types of accounts to lower overall risk (page 158)

**DRAWING FROM EXPERIENCE**

Did you know that people save money for both short-term and long-term purposes? Do you know what a pension plan is? In addition to savings, most Americans will need supplementary sources of income for their retirement years.

This section focuses on saving and investing for retirement. It also outlines the different retirement plans available.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read through the summaries that follow. Think about why it might be important to save money for retirement.

<table>
<thead>
<tr>
<th>Individual Pension Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Name of Plan</strong></td>
</tr>
<tr>
<td>Keogh Plan</td>
</tr>
<tr>
<td>individual retirement account (IRA)</td>
</tr>
<tr>
<td>Roth IRA</td>
</tr>
</tbody>
</table>


Most Americans will need to supplement their savings in the years after they stop working. There are several sources of retirement investment, and they carry different levels of risk.

**Investing for Retirement (page 155)**

Most working people are eligible for Social Security payments when they reach retirement. However, Social Security payments are very small. That is why it is important to invest additional money in order to live comfortably during retirement. Many companies offer pension plans, which provide retirement income to employees. The most common pension plan is called a 401(k) plan. An employee contributes a certain percentage of his or her paycheck to the 401(k) plan. The employer matches that contribution, usually doubling the amount contributed by the employee. The money is available to the employee when he or she reaches retirement age.

There are tax benefits to contributing to company pension plans. The employee does not pay federal income tax immediately on the money contributed to a pension plan. Nor does the employee pay federal income tax on the interest if it does not exceed a certain amount. The employee does, however, pay a tax penalty if he or she takes money out of the plan early. When the employee reaches retirement, he or she will pay income tax on the money as it is withdrawn.

A person who is self-employed can contribute to a retirement plan called a Keogh Plan. A person can contribute 15 percent of his or her income to a Keogh Plan. The person then deducts the amount contributed from his or her yearly taxable income.

Another retirement plan is called the individual retirement plan (IRA). The income a person contributes to an IRA is not taxed in the year it is contributed. The interest earned on the contribution is not taxed either. Taxes are paid only when an individual takes funds out of the IRA.

A Roth IRA allows individuals to contribute up to $3,000 each year. Individuals do not get to deduct that amount from their taxable income. All of the interest earned on contributions to a Roth IRA is forever tax-free.

Some people invest their money in real estate for retirement. For the last 50 years, real estate prices have generally gone up, making real estate a wise investment. The trade-off is that sometimes it can take a long time to sell property. Money invested in stocks and bonds, a retirement plan, or even a savings account can be accessed more easily. If an individual invests in real estate, he or she might have to wait months to sell the property and access the money originally invested.

1. Why is it important to contribute to a retirement plan?

**How Much To Save and Invest? (page 157)**

Saving or investing involves a trade-off. The more you save or invest today, the less money you have to spend today. You can answer the following questions to help determine how much income you should save or invest.
A. How much do you spend on your fixed expenses? Fixed expenses are expenses such as food and housing that are constant.

B. What are your reasons for saving?

C. How much interest can you earn on your savings? How fast will your savings grow?

D. How much income will you be earning in the future?

You should answer the following questions before deciding what savings plan is right for you.

A. What degree of risk on investments are you willing to take with your savings?

B. How important is it that your savings be readily available in case you need immediate cash?

C. Will your standard of living at retirement depend largely on your accumulated savings?

The degree of risk is probably the most important consideration when deciding on a savings or investment plan. Investing in stocks and bonds, savings accounts, or retirement plans each carry differing levels of risk. Many people invest savings in several different types of accounts to lower the overall risk. Financial planners call this diversification. For example, an individual might have money in a savings account, money invested in mutual funds, and money in a 401(k) plan at his or her place of employment. People with very little income usually save money in an insured account such as a savings account or U.S. government savings bonds. The more money and savings a person has, the more he or she can diversify into stocks, bonds, and other investments.

A person’s values can play a part in their investment decisions. For example, some people put their money in local savings and loan associations because those institutions invest money in their local community. Some people might choose to invest their money in companies that are environmentally responsible.

2. What questions should a person answer before deciding on the right savings plan?
DEMAND

KEY TERMS

demand Amount of a good or service that consumers are able and willing to buy at various possible prices during a specified time period (page 170)
supply Amount of a good or service that producers are able and willing to sell at various prices during a specified time period (page 170)
market Process of freely exchanging goods and services between buyers and sellers (page 170)
voluntary exchange Transaction in which a buyer and a seller exercise their economic freedom by working out their own terms of exchange (page 170)
law of demand Economic rule stating that the quantity demanded and price move in opposite directions (page 171)
quantity demanded Amount of a good or service that a consumer is willing and able to purchase at a specific price (page 172)
real income effect Economic rule stating that individuals cannot keep buying the same quantity of a product if its price rises while their income stays the same (page 172)
substitution effect Economic rule stating that if two items satisfy the same need and the price of one rises, people will buy the other (page 172)
utility The ability of any good or service to satisfy consumer wants (page 173)
marginal utility An additional amount of satisfaction (page 174)
law of diminishing marginal utility Economic rule stating that the additional satisfaction a consumer gets from purchasing one more unit of a product will lessen with each additional unit purchased (page 174)

DRAWING FROM EXPERIENCE

Have you ever seen something on the store shelf and thought, “I wonder who would ever buy that”? Perhaps you did not want it, but someone else did. The greater the number of people who want an item, the more of such items producers will supply.

This section focuses on the willingness and ability of people to purchase particular goods and services—what economists call demand.
ORGANIZING YOUR THOUGHTS

Use the cause-and-effect diagram below to help you take notes as you read the summaries that follow. Think about how price changes affect the amounts of goods people buy.

<table>
<thead>
<tr>
<th>Change in Price</th>
<th>Effect on Demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the price increases,</td>
<td>then demand _________</td>
</tr>
<tr>
<td>If the price decreases,</td>
<td>then demand _________</td>
</tr>
</tbody>
</table>

READ TO LEARN

Introduction (page 169)

Demand includes only those people who are both willing and able to buy something.

The “Marketplace” (page 169)

Did you know that when you buy something you are having an influence over the price of that item? Together buyers and sellers in a market economy determine prices. All consumers together help to determine the price of goods and services through demand. Consumer decisions determine what products will sell and for how much. The people who sell those items also decide how much to sell and at what price. This is called supply.

The market represents the freely chosen actions between buyers and sellers of goods and services. A market can be local, national, international, or a combination of these. In a market economy, buyers or sellers decide for themselves the answers to the economic questions WHAT?, HOW?, and FOR WHOM?

1. How are prices determined in a market?

Voluntary Exchange (page 170)

Buyers and sellers are free to make choices in a market economy. Their decisions represent the principle called voluntary exchange. In order for such an exchange to take place, the buyer and seller must agree on the price and be satisfied that they will be better off for having made the exchange.

Economists analyze the actions of buyers and sellers in the marketplace to show how supply and demand affect prices.

2. What conditions must be met in order for a voluntary exchange to take place in the market?
Demand represents the goods or services that consumers are both willing and able to purchase at various prices. The Law of Demand explains how people react to changes in price. It states:

As price goes up, quantity demanded goes down.
As price goes down, quantity demanded goes up.

In other words, more people will buy more of an item if the price is lowered. There is an inverse relationship between price and quantity demanded. When one goes up the other goes down.

There are three other reasons that people will adjust the amount they are willing to buy. First, real income effect means that if a person’s real income decreases he or she will purchase less. If real income goes up, people will purchase more. Second, substitution effect says that people may substitute one item for another. This will happen if there are two items that satisfy the same need, and their cost is about the same. If the price of one falls, people will most likely buy it instead of the other good.

Finally, diminishing marginal utility affects how much people will purchase. You purchase things in order to receive satisfaction. The term that economists use for satisfaction is utility—the power that a good or service has to satisfy a want. A cold soft drink at a baseball game on a hot day provides utility. How many cups will you purchase? The decision depends on the satisfaction, you expect to receive from each additional soft drink. Your total satisfaction will rise with each one bought. The amount of additional satisfaction, or marginal utility, diminishes, or lessens, with each additional cup. This illustrates the law of diminishing marginal utility.

At some point, you will stop buying soft drinks altogether. Sometimes, however, if the price is lowered, you will consider another purchase. So, while you may not buy another drink for $3, you might buy one for $1.

**3. How do the real income effect, substitution effect, and law of marginal utility relate to the law of demand?**
THE DEMAND CURVE AND ELASTICITY OF DEMAND

**KEY TERMS**

- **demand schedule**: Table showing quantities that would be demanded at various prices (page 178)
- **demand curve**: Downward-sloping line that graphs the quantities demanded at each possible price (page 179)
- **complementary good**: For a product often used with another product; as the price of one product decreases, the demand for the other increases (page 181)
- **elasticity**: Measures consumers’ responsiveness to an increase or decrease in price (page 181)
- **price elasticity of demand**: Measures the amount that demand varies according to changes in price (page 181)
- **elastic demand**: The rise or fall in a product’s price greatly affects the amount that people are willing to buy (page 184)
- **inelastic demand**: A product’s price change has little impact on the quantity demanded by consumers (page 184)

**DRAWING FROM EXPERIENCE**

If the price of gasoline drops significantly, people travel more. However, if the price of salt drops sharply, people still buy the same amount of salt.

This section focuses on the measurement of change in buying habits when prices change. It is called elasticity of demand.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you remember the summaries that follow.

<table>
<thead>
<tr>
<th>What Determines Demand?</th>
<th>What Determines Price Elasticity of Demand?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
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<tr>
<td>2</td>
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<td>3</td>
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<td>4</td>
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<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

• Graphing the Demand Curve (page 177)

Economists use graphs to show the relationship between two sets of statistics or two concepts. The law of demand can be graphed to show that as the price goes up, quantity demanded goes down, and vice versa.

To create a demand curve graph, first you need a demand schedule—a table of prices and quantity demanded. The schedule shows the relationship of price to quantity demanded. To plot the numbers from the schedule onto a graph, use the bottom (or horizontal) axis to show the quantity demanded. The side (or vertical) axis will show the price per item. Each pair of numbers (price and quantity demanded) represents a point on the graph. When the points are connected with a line, we end up with the demand curve. A demand curve shows the quantity demanded of a good or service at each possible price. Demand curves always slope downward from left to right.

1. Why does the demand curve on a graph slope downward?

• Quantity Demanded Versus Demand (page 180)

Quantity demanded is a specific point on the demand curve that shows how much is demanded at a specific price. However, a change in quantity demanded is caused by a change in price. This is shown as a movement to a different point along the demand curve.

Sometimes, however, something other than price causes demand to increase or decrease. This is known as a change in demand and is shown as a shift of the entire demand curve. The curve may shift to the left (decrease in demand) or right (increase in demand). If demand increases, people will buy more per year at all prices. If demand decreases, people will buy less per year at all prices.

2. What is the difference between a change in quantity demanded and a change in demand?

• Determinants of Demand (page 180)

What causes a change in demand? Many factors can affect demand for a specific product. First, consider changes in population. When population increases, the demand for most products increases. This means that the demand curve for products like television sets, shifts to the right. At each price, more television sets will be demanded.

Second, demand for most goods and services depends on income. For example, the demand curve for CDs will shift to the left if people’s income goes down. Having less to spend, they will demand fewer CDs at all possible prices.

Third, changes in tastes and preferences determine demand. Tastes and preferences refer to what people like and prefer to choose. Fads best illustrate the changes in demand caused by tastes and preferences. When a fad dies out, fewer goods are sold at every possible price.
Fourth, the existence of substitutes also affects demand. Consider butter and margarine. If the price of butter remains the same and the price of margarine falls, people will buy more margarine and less butter at all prices of butter. The demand curve for butter will shift to the left.

Finally, when two goods are complementary products, the decrease in the price of one will increase the demand for it as well as its complementary good. For example, cameras and film are complementary goods. If the price of cameras drops, people will probably buy more of them. They will also probably buy more film to use with the cameras. So, a decrease in the price of cameras leads to an increase in the demand for its complementary good, film.

3. What are the five determinants of demand?

The Price Elasticity of Demand (page 181)

If you were the owner of a music store, you might use the law of demand to determine your prices for DVDs. If you lower prices, consumers will buy more DVDs. By how much should you lower the price? You cannot answer this question unless you know how responsive consumers will be to a decrease in the price. Economists call this price responsiveness elasticity. They measure the price elasticity of demand—how much consumers respond to a given change in price.

The demand for some goods is elastic. That means a rise or fall in price greatly affects the amount people are willing to buy. For example, any particular brand of coffee probably has elastic demand. Because there are many competing brands of coffee a small rise in the price of one brand will probably cause many consumers to purchase the cheaper substitute.

If a price change does not result in a substantial change in the quantity demanded, that demand is considered inelastic. Salt, pepper, sugar, and certain types of medicine normally have inelastic demand. If the cost of salt were cut in half, for example, you probably would still use about the same amount.

At least three factors determine the price elasticity of demand for a particular item:

1. the existence and similarity of substitutes; (2) the percentage of a person’s total budget devoted to the purchase of that good; (3) the amount of time consumers are given to adjust to a change in price.

If suitable substitutes exist, prices for an item are elastic. People will not buy much of an item that is considered too expensive, if they can substitute another item. However, if the percentage of your budget you spend on an item is small, demand is inelastic. For example, you will not likely change your consumption of pepper if the price doubles. On the other hand, if the price of a particular new car doubles, many people will buy a different make of car. The demand for pepper, then, is relatively inelastic, while demand for new cars is relatively elastic.

Finally, people take time to adjust and adapt to changes in prices. If the price of electricity goes up by 100 percent tomorrow, you will have a hard time adjusting your behavior immediately. Over time you will figure out ways to reduce the amount of electricity you use—by putting in lower wattage light bulbs, adding insulation to your attic and so on. Therefore, the longer the time allowed for adjustment to the changes, the greater the price elasticity of demand.
4. What is the price elasticity of demand and what factors help to determine it?
**KEY TERMS**

- **law of supply** Economic rule that price and quantity supplied move in the same direction (page 187)
- **quantity supplied** The amount of a good or service that a producer will supply at a specific price (page 187)
- **supply schedule** Table showing quantities supplied at different possible prices (page 188)
- **supply curve** Upward-sloping line on graph that shows the quantities supplied at each possible price (page 189)
- **technology** Any use of land, labor, and capital that produces goods and services more efficiently (page 190)
- **law of diminishing returns** Economic rule that says as more units of production (such as labor) are added, total output increases at a diminishing rate (page 192)

**DRAWING FROM EXPERIENCE**

How many apple pies could you produce in your kitchen in two hours? The answer depends on the size of your oven, among other things. If you had two ovens, you might double production, but that would require more cooks. Increasing production always requires additional inputs. Businesses increase production only when they foresee additional profits.

This section focuses on the law of supply and how it is affected by profits.

**ORGANIZING YOUR THOUGHTS**

Use the cause-and-effect diagram below to help you take notes as you read the summaries that follow. Think about how the supply curve is affected by the following determinants of supply.

<table>
<thead>
<tr>
<th>Cause</th>
<th>Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price of inputs goes down</td>
<td></td>
</tr>
<tr>
<td>Number of firms in the industry increases</td>
<td></td>
</tr>
<tr>
<td>Taxes go up</td>
<td></td>
</tr>
<tr>
<td>Technology improves</td>
<td></td>
</tr>
</tbody>
</table>

**READ TO LEARN**

- **Introduction** (page 186)

While consumers demand products at the lowest possible prices, producers seek the highest possible profits.
The Law of Supply (page 186)

The law of supply states the direct relationship between the quantity supplied and price: As the price of a good rises, the quantity supplied rises. As the price falls, the quantity supplied falls. A larger quantity of goods or services will be supplied at higher prices than at lower prices.

1. How does the relationship between price and quantity supplied differ from that between demand and quantity supplied?

The Incentive of Greater Profits (page 187)

For a producer, being able to charge higher prices means higher profits. It also means the additional costs of increasing production will be covered. If a company wants to expand production, it must project the additional costs of such things as overtime pay, more machinery, repairs to machinery, etc. These costs must be met before profits are available.

2. What motivates suppliers in a market economy?

The Supply Curve (page 188)

Like the demand curve, a supply curve can be built from a supply schedule, or table that lists the number of items supplied at each given price. On the supply curve the bottom axis shows the quantity supplied, while the side axis shows the price per item. The curve rises from the bottom left to the top right, showing that as prices rise, so does quantity supplied.

3. Is the relationship between price and quantity supplied direct or inverse?

Quantity Supplied vs. Supply (page 189)

The supply curve shows that the quantity supplied will change when the price changes. Sometimes, however, other factors will enable producers to supply more goods or fewer goods at every price along the curve. In this case, the supply curve itself will shift to the left or right. This movement of the supply curve is called a change in supply. It is not the same as a change in quantity supplied.

4. What does a change in supply do to the supply curve?

The Determinants of Supply (page 190)

Four major determinants of supply cause the entire supply curve to shift left or right.

A. Price of Inputs—If the price of raw materials, wages, or other inputs drops, a producer can supply more at a lower production cost. So, the supply curve shifts to the right. When the price of inputs rises, the curve shifts to the left.
B. Number of Firms in the Industry—If more firms enter the industry, greater quantities are supplied at every price, and the supply curve shifts right.

C. Taxes—Increases in taxes on business raise the cost of production, so the supply curve shifts left as fewer quantities are produced at every price.

D. Technology—An improvement in technology increases supply because it reduces the cost of production.

5. What would happen to the supply curve for computer chips if a firm found a more efficient way of producing them?

[ The Law of Diminishing Returns (page 192) ]

The law of diminishing returns states that as more units of a factor of production are added, at some point the rate of increased production will diminish. For example, hiring one additional worker will increase production. Hiring 10 more workers may not increase production 10 times as much because too many workers may be crowded into too little space. Total output goes up with each additional worker added, but it does not continue to increase at the same rate.

6. What are the “returns” that diminish according to this law?
PUTTING SUPPLY AND DEMAND TOGETHER

KEY TERMS

- **equilibrium price** The price at which quantity demanded and quantity supplied meet (page 195)
- **shortage** Condition that occurs when quantity demanded is greater than quantity supplied (page 196)
- **surplus** Condition that occurs when quantity demanded is less than quantity supplied (page 196)
- **price ceiling** A government-set maximum price (page 197)
- **rationing** Limiting distribution of items that are in short supply (page 197)
- **black market** An illegal market in which high prices are charged for items in short supply (page 197)
- **price floor** Government-set minimum price (page 198)

DRAWING FROM EXPERIENCE

How much would you expect to pay for a banana? One cent? One dollar? You realize that one cent is too low and one dollar is too high. Why do bananas and other goods sell within a narrow range of prices? The forces of demand and supply tend to create an equilibrium price.

ORGANIZING YOUR THOUGHTS

Use this graph to label the quantity demanded and quantity supplied lines. Then label the equilibrium price.

READ TO LEARN

- **Introduction** (page 194)

  Shortages occur when the quantity demanded is larger than the quantity supplied at the current price.

- **Equilibrium Price** (page 194)

  The forces of demand and supply operate together. Does quantity supplied ever equal quantity demanded? Yes, at a level called the **equilibrium price** the producers supply the exact amount of
product that consumers demand. This can be visualized by placing demand curve and supply curve information on the same graph. Where the two curves intersect is the equilibrium price.

1. What is the equilibrium price?

---

**Shifts in Equilibrium Price** *(page 195)*

Because supply and demand work together to set prices, a change in supply or in demand affects the equilibrium price. For example, if a change in technology enables a producer to supply more goods, the supply curve shifts to the right. If consumer tastes cause demand to increase, the demand curve shifts right also. When both supply and demand curves shift, a new equilibrium price is established.

2. Where is the new equilibrium price, when both supply and demand curves shift?

---

**Prices Serve as Signals** *(page 196)*

Prices serve as signals to producers and consumers, changing both supply and demand.

A *shortage* occurs when, at the current price, more of a product is demanded than is supplied. This puts pressure on prices to rise, thus reducing demand.

A *surplus* happens when suppliers produce more than consumers want at a given price. Inventories of the goods build up, putting pressure on prices to fall.

The market eliminates shortages and surpluses by raising and lowering prices. However, sometimes the government intervenes to help set prices.

3. How does the market eliminate shortages and surpluses?

---

**Price Controls** *(page 197)*

Sometimes the government intervenes in the market to set price ceilings or price floors.

When the government determines that market conditions have allowed prices for a certain good or service to go too high, it may set a *price ceiling*—a maximum price that can be charged. Because of the lower prices, a shortage may develop. When that happens, the government may respond by *rationing*, or limiting the items that are in short supply. Shortages may also lead to a black market, an illegal market in which items in short supply can be bought for very high prices.
What if the price for a certain item drops too low? Suppose, for example that the equilibrium price for fast-food workers is $4.15 per hour. If the government believes that wages are too low, it can establish a price floor, called a minimum wage. At a wage of $5.15 there will be more people willing to work than there are jobs offered. At the equilibrium wage the supply of workers equaled the demand for them. Price floors have been used to support agricultural prices in order to keep farmers in business. The result may be a surplus of certain farm goods.

4. How may price floors and ceilings destroy market equilibrium?
STUDY GUIDE

Chapter 8, Section 1

For use with textbook pages 207–211

STARTING A BUSINESS

KEY TERMS

entrepreneur  Person who hopes to gain profit from the risks of organizing, managing, and starting a business (page 208)
startup  The process of beginning a business or enterprise (page 208)
small business incubator  Private or government-funded agency which provides low-cost buildings and supplies or advice to help new businesses to grow (page 209)
inventory  Ready supply of extra goods or raw materials necessary for the operation of a business (page 209)
receipts  Records, such as slips of paper or data stored in computer files, which keep track of sales and purchases; also, income received from the sale of a good or service (page 209)

DRAWING FROM EXPERIENCE

Have you ever wanted to start your own business? What product or service would you sell? How would you organize your business? Do you need any special equipment or advice to start your business? How would you tell people about your business?

This section focuses on the decisions and the steps a person takes to start a business.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the things that must be done to start a business and the four elements involved in every business.

<table>
<thead>
<tr>
<th>Steps to Starting a New Business</th>
<th>Four Elements of Every Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1.</td>
</tr>
<tr>
<td>2.</td>
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<tr>
<td>3.</td>
<td>3.</td>
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<tr>
<td>4.</td>
<td>4.</td>
</tr>
</tbody>
</table>
READ TO LEARN

Getting Started (page 207)

Anyone who assumes the risk of starting a new business becomes an entrepreneur. An entrepreneur must decide which products or services will be sold. Then, he or she must gather the elements necessary to start the business. In the startup phase, an entrepreneur gathers the products that will be sold or the materials necessary to help him or her to perform a service. The entrepreneur also learns as much as possible about the laws, regulations, and tax codes that apply to his or her business. Some small businesses might find help from small business incubators. These government agencies provide low-rent buildings and advice to help new enterprises.

1. What steps does a person need to follow when starting a new business?

Elements of Business Operation (page 209)

Every business must consider the following four basic elements.

A. Expenses are the costs of operating a business including wages, taxes, and supplies used in your business. When you subtract your total expenses from your receipts, you will have your profit.

B. Advertising makes potential customers aware of the goods or services offered by your business.

C. Record keeping helps to determine your success by tracking expenses and income. The difference between what you own and what you owe is net worth.

D. Risk is created by the choices made while operating a business.

2. Describe the four elements involved in every business operation.
Sole Proprietorships and Partnerships

**KEY TERMS**

- **sole proprietorship** Business owned and operated by one person (page 213)
- **proprietor** Person who owns a business (page 215)
- **unlimited liability** An owner is personally and completely responsible for all of the debts or losses of his or her business (page 215)
- **assets** All items legally owned by a business or household (page 215)
- **partnership** Business owned and operated by two or more people (page 215)
- **limited partnership** Special partnership arrangement where one or more of the people involved have limited liability, but cannot make management decisions (page 217)
- **joint venture** Temporary partnership created to achieve a specific purpose (page 217)

**DRAWING FROM EXPERIENCE**

Have you ever tried to do something complicated by yourself? How difficult was it? Could the task have been completed more easily or more quickly with the help of some friends? Did you wish that you had extra money to purchase a special tool for the job?

This section discusses the characteristics of sole proprietorships and partnerships.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about the differences between sole proprietorship and partnership.

<table>
<thead>
<tr>
<th>Sole Proprietorship</th>
<th>Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
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<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
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</tbody>
</table>
READ TO LEARN

**Sole Proprietorships** (page 213)

A sole proprietorship is a business owned and operated by one person. It is the most basic and most common form of business organization. The sole proprietor enjoys the advantage of keeping all profits, making independent management decisions, obtaining easy credit, and the pride of ownership. The major disadvantage to this organization is the owner’s unlimited liability. Sole proprietors are personally responsible for all debts and obligations relating to the business. Running a sole proprietorship is demanding and time consuming, and the sole proprietor must make all of the decisions.

1. What are other advantages and disadvantages of a sole proprietorship?

**Partnerships** (page 215)

Partnerships spread the risks and workload of running a business among two or more people. This organization allows each partner to focus on a specialized area of the business such as handling customers or keeping the books. Partners can also provide money for expanding a growing business. The main disadvantages are that each partner can make management decisions, and each partner is exposed to unlimited liability. Disagreements between partners can lead to problems in running the business.

*Limited Partnerships* and *Joint Ventures* are special forms of partnerships. In a limited partnership, the general partner assumes unlimited liability for business debts and makes all management decisions. The limited partner contributes money or property in exchange for a share of the profits. Limited partners do not make management decisions, but they enjoy limited liability. A joint venture is a temporary agreement between people or businesses for the completion of a specific project. Once the project is completed, the joint venture ends.

2. What advantages might there be in changing a business from a sole proprietorship to a partnership, and how do limited partnerships differ from joint ventures?
corporation  Business organization owned by many people, but treated as a person by law. For example, it can own property, pay taxes, and make contracts (page 220)
stock  Allows a person to purchase a specific part of a corporation’s future profits or assets (page 220)
limited liability  An owner’s responsibility for the company’s debts is limited only to the size of the owner’s investment (page 220)
articles of incorporation  Registers basic information about the corporation with the state where the corporation will have its headquarters (page 221)
corporate charter  A license to operate a corporation within a state’s borders (page 221)
common stock  Ownership shares in a corporation, which allow its owners voting rights and a portion of future profits after preferred stockholders are paid (page 223)
dividend  A portion of the corporation’s profit paid to stockholders (page 223)
preferred stock  An ownership share in a corporation that does not have voting rights, but stockholders receive a portion of future profit before others (page 223)
franchise  One business, the franchiser, sells the right to use its name and products to another company known as the franchisee (page 224)

DRAWING FROM EXPERIENCE
Have you ever been a member of a club or team? How was your organization created? Do you raise money to pay for activities? Who selected your organization’s leaders?
This section explains how a corporation, a form of business organization, is structured.

ORGANIZING YOUR THOUGHTS
Use the diagram below to help you take notes as you read the following summaries. Think about the steps involved in forming a corporation.

<table>
<thead>
<tr>
<th>Step</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registering the Corporation</td>
<td></td>
</tr>
<tr>
<td>Selling Stock</td>
<td>Common: Preferred:</td>
</tr>
<tr>
<td>Selecting Board of Directors</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

Why Form a Corporation? (page 219)

Corporations allow businesses to expand and to buy the latest equipment without having to consult partners about every detail of operating the business. Several people, the stockholders, own corporations, but the law treats a corporation as a single person who can purchase property, pay taxes, make contracts, and sue or be sued. Corporations are the most significant business organizations in the United States today. They earn 90 percent of all business revenues. Many modern corporations are huge. They may have offices and factories in several counties. A study in the mid-1990s found that more than half of the world’s 100 largest economies belonged to corporations, like General Motors, rather than nations. An advantage to forming a corporation is that stockholders enjoy limited liability for business debts or losses. A corporation’s major disadvantage is that they are taxed more heavily than other business organizations.

1. What are the benefits and drawbacks of forming a corporation?

Corporate Structure (page 221)

Founders of a new corporation must register their company with the state government where their headquarters are located. State governments require you to file articles of incorporation with four items.

A. Name, address, and purpose of the corporation
B. Names and addresses of the men and women who serve as the initial board of directors
C. Number of shares of stock to be issued
D. Amount of money capital to be raised through the sale of stocks

After registering, the state may allow the corporation to conduct business within its borders by issuing a corporate charter. A corporation then may raise money capital by selling common or preferred stocks. Common stock gives the investor part ownership in the company, a portion of future profits, and voting rights at annual shareholder meetings. Preferred stocks guarantee each investor a dividend, which is a money return on money invested in the company’s stock, but preferred stockholders are not allowed to vote at shareholder meetings. Also, preferred stockholders have first claim on any value left in the company after all creditors are paid. New corporations must name a board of directors. The board of directors supervises and controls the corporation by hiring company officers, such as the president, and establishing bylaws. Bylaws describe the duties of company officers and set the rules for selling stocks and paying dividends.

2. How are corporations established?
Franchises (page 224)

Many hotel, motel, gas station, and fast-food chains are franchises. A franchise is created when one business, the franchiser, sells the right to use its name and the right to sell its products to another business. Franchisees, people or businesses who purchase a franchise, may pay a fixed fee for these rights, or they may pay a fee plus a portion of future profits from the business. Franchisers often help franchisees by providing training programs and setting standards of business operation.

3. How do franchises differ from corporations?
PERFECT COMPETITION

KEY TERMS

market structure  The extent to which competition prevails in particular markets (page 233)
perfect competition  A market situation in which there are numerous buyers and sellers. No single buyer or seller can affect price (page 234)

DRAWING FROM EXPERIENCE

Have you ever played a game against someone with equal skill? Have you ever played against someone that you dominated or who dominated you? How did your competitive feelings differ? Were you more or less likely to try different things to win?

In this section, you will learn about the ideal market structure of perfect competition.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the characteristics of perfect competition.

READ TO LEARN

Market Structure (page 233)

Businesses can be categorized by the amount of competition they face—or market structure. There are four basic market structures in the American economy: perfect competition, monopolistic competition, oligopoly, and monopoly.

1. Name the four basic market structures that can be found in the American economy.
**Conditions of Perfect Competition** (page 234)

Competition is advantageous to consumers because it provides choices and leads to surpluses and lower prices. Perfect competition exists when a market includes so many sellers of a particular good or service that each seller accounts for a small part of the total market. For perfect competition to exist, five conditions must be met.

A. A large market must exist
B. Similar products or services must be sold
C. Easy market entry and exit
D. Easily obtainable information about prices, quality, and sources of supply
E. Independence; there is no possibility of sellers or buyers working together to control prices.

When these conditions are met, the market forces of supply and demand control price. Market price is the equilibrium price. Information is key to perfect competition because a large number of informed buyers must know the market price. The Internet makes this easier than at any time in the past.

2. How do consumers benefit from perfect competition?

**Agriculture as an Example** (page 236)

Agriculture markets come the closest to perfect competition because individual farmers have almost no control over the market price. Wheat prices provide a good example because demand for this product is inelastic. The equilibrium price, or the point at which the supply and demand curves intersect, is the market price.

3. Why are agriculture markets considered to be the closest to perfect competition?

**Benefits to Society** (page 237)

Intense competition in a perfectly competitive industry forces prices down to a level that just covers the costs of production plus a small profit. Consumers pay the correct value of that product in society. Production becomes more efficient because no arrangement of the factors of production would generate a higher valued output. Society thus enjoys an efficient allocation of productive resources.

4. Why does perfect competition benefit society?
**MONOPOLY, OLIGOPOLY, AND MONOPOLISTIC COMPETITION**

**KEY TERMS**

- **monopoly** A market situation controlled by a single supplier of a good or service that has no close substitute (page 240)
- **barriers to entry** Obstacles to competition that prevent others from entering into a market (page 240)
- **economies of scale** Long-run average costs of production decrease as a result of large size or scale of output (page 241)
- **patent** A government protection given to an inventor. The inventor receives exclusive rights to make, use, or sell an invention for a specified number of years (page 241)
- **copyright** A government protection that allows authors or artists the exclusive right to sell, publish, or reproduce their works for a specified number of years (page 241)
- **oligopoly** Industry dominated by a few suppliers who exercise some control over price (page 243)
- **product differentiation** Manufacturers try to differentiate their product from others by emphasizing minor differences in quality and features (page 244)
- **cartel** An arrangement among groups of industrial businesses, often in different countries, to reduce international competition by controlling the price, production, and distribution of goods (page 245)
- **monopolistic competition** A market situation in which a large number of sellers offer similar but slightly different products. Each seller has some control over price (page 245)

**DRAWING FROM EXPERIENCE**

When was the last time you bought a pair of jeans or an automobile? What were the differences between the brand or model you bought and others available in the market? Why did you choose one brand or model over another?

In this section, you will learn that advertising plays a major role in two types of market structures.

**ORGANIZING YOUR THOUGHTS**

Use the diagrams below to help you take notes as you read the summaries that follow. Think about the characteristics of a pure monopoly, an oligopoly, and monopolistic competition.
READ TO LEARN

Imperfect Competition (page 239)

Most industries in the U.S. represent some form of imperfect competition. Economists classify these three types of imperfect market structures as monopoly, oligopoly, or monopolistic competition. They differ on the basis of how much competition and control over price the seller has.

1. What characteristics can be used to recognize the differences between the three types of imperfect market structure?

Monopoly (page 240)

A pure monopoly is the most extreme form of imperfect competition. One single seller controls the supply of the good or service provided. The seller also sets the price. Consumers have no other choice but to purchase their goods from the supplier. A pure monopoly has four characteristics.

1. A single seller controls the available supply of a good or service.
2. No substitutes exist for the goods or services sold by the monopoly.
3. No entry. A monopolist is protected by obstacles to competition that prevent others from entering the market.
4. Almost complete control of market price by the monopolist who controls the available supply.

In a pure monopoly, a supplier can raise prices without fear of losing business to competitors. The law of demand still operates. It prevents monopolists from charging outrageous prices.

Major barriers to entry include government regulations, large initial investment, and ownership of raw materials.

2. What is a pure monopoly?

Types of Monopolies (page 241)

Pure monopolies can be separated into four categories depending on why the monopoly exists.

1. Natural monopolies In the past, it was thought to be more efficient to have just one company provide a public service or good, such as utilities. Competition was believed to lead to a wasteful duplication of costs. Natural monopolies were thought to be more efficient. They possessed the benefits of economies of scale—by which they could produce the largest amounts of goods for the lowest cost. Recently, government has begun to deregulate natural monopolies because advances in technology can make these industries more competitive.
2. **Geographic monopolies** occur when the potential for profits in a given location is so small that other businesses choose not to enter the market. Competition from mail-order catalogs and delivery services are reducing the number of these monopolies.

3. **Technological monopolies** are created by **patents** and **copyrights**. A patent gives you the exclusive right to manufacture, rent, or sell your invention for a specified number of years. Copyrights permit authors and artists to similarly control their creative works.

4. A **government monopoly** is similar to a natural monopoly, but the monopoly is owned by the government.

Today monopolies are far less important than in the past. In general, technology tends to reduce monopolies over time.

3. **What are the four categories of monopolies?**

---

**Oligopoly** (page 243)

An oligopoly is an industry dominated by several suppliers who exercise some control over price. It possesses five characteristics:

1. **Domination by a few sellers** who are responsible for 70 to 80 percent of the market.
2. **Barriers to entry** caused by high capital costs making it difficult for new companies to enter major markets.
3. **Identical or slightly different products**
4. **Non-price competition** involving product differentiation. **Product differentiation** emphasizes the minor differences between similar products in an attempt to build customer loyalty. The price paid for brand named products is based on the real or perceived differences in a good or service.
5. **Interdependence** Any change on the part of one firm will cause others in the oligopoly to make similar changes.

Members of the oligopoly may engage in secret agreements to raise price or to divide the market. This is an illegal act called **collusion**. **Cartels** are an international form of collusion. Industrial businesses arrange to reduce international competition by controlling price, production, and the distribution of goods.

Oligopolies are not considered as harmful to consumers as monopolies. While consumers may pay more than in a perfectly competitive market, oligopolies tend to have generally stable prices and they offer a wider variety of products than a perfectly competitive industry.
4. Why do oligopolies have limited control over prices?

□ Monopolistic Competition (page 245)

This type of competition occurs when a large number of sellers offer similar, but slightly different goods or services. Monopolistic competition is defined by five characteristics that are similar to those of an oligopoly.

1. **Numerous Sellers**—No single seller or small group dominates the market.
2. **Relatively Easy Entry**—Entry into the market easier than in a monopoly or oligopoly.
3. **Differentiated Products**—Each supplier sells a slightly different product to attract customers.
4. **Non-price Competition**—Businesses compete by using product differentiation and by advertising.
5. **Some Control Over Price**—By building a loyal customer base through product differentiation, each firm has control over the price it charges.

Monopolistic competition is different from an oligopoly because the many firms have no real interdependence and some slight difference exists among competing products. Advertising is even more important in product differentiation.

5. What are the two main differences between an oligopoly and monopolistic competition?
KEY TERMS

**interlocking directorate**  The majority of a board of directors for one company also serve as the board of directors for a competing corporation (page 249)

**antitrust legislation**  Federal and state government laws passed to prevent new monopolies from forming and to break up those that already exist (page 249)

**merger**  A combined company that results when one corporation buys more than half the stock of another corporation and, thus, controls the second corporation (page 249)

**conglomerate**  A large corporation made up of smaller corporations dealing in unrelated businesses (page 250)

**deregulation**  Government reduction in the amount of regulation and control that it has over business activity (page 253)

DRAWING FROM EXPERIENCE

Who sets the rules for classroom behavior in your school? What type of rules are you required to follow? What type of environment do these rules try to create?

In this section, you will learn about federal laws and regulatory agencies that attempt to shape the business environment and force monopolies to act more competitively.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the differences between interlocking directorates and mergers.

<table>
<thead>
<tr>
<th>Interlocking Directorates</th>
<th>Types of Mergers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>definition:</strong></td>
<td>1.</td>
</tr>
<tr>
<td></td>
<td>2.</td>
</tr>
<tr>
<td></td>
<td>3.</td>
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</tbody>
</table>
READ TO LEARN

**Antitrust Legislation** (page 248)

Big businesses emerged after the Civil War. John D. Rockefeller’s Standard Oil Company was notorious for creating **interlocking directorates**. He controlled competitors by placing members of Standard Oil’s board of directors onto the boards of rival corporations. In 1890, the Sherman Antitrust Act tried to protect trade and commerce against unlawful restraint and monopoly as practiced by Rockefeller. **Antitrust legislation** tries to prevent new monopolies or trusts from forming. It also attempts to break up those that already exist. The 1914 Clayton Act allows the federal government to block mergers that might substantially lessen competition.

1. What was the name of the act that first tried to stop the practice of creating interlocking directorates?

**Mergers** (page 249)

A merger occurs when one corporation joins with another corporation. Most antitrust legislation deals with restricting the harmful effects of mergers. There are three general types of mergers.

1. **Horizontal mergers** occur when two corporations competing in the same business merge.
2. **Vertical mergers** occur when corporations involved in a “chain” of supply merge.
3. **Conglomerate mergers** occur when two huge corporations involved in at least four or more unrelated businesses join together.

2. What are the three types of mergers?

**Regulatory Agencies** (page 251)

Federal and local governments also use direct regulation of business pricing and product quality to foster a competitive atmosphere. Government regulations try to promote efficiency and competition. Recent evidence indicates that government regulations had actually decreased the amount of competition in the economy. In the 1980s and 1990s, many industries were deregulated. This means that government reduced regulations and control over business activities. Many economists speculate about what would happen if the government removed all regulations toward mergers. They assume prices would rise until profits became excessive. At this point, other sellers would enter the market. Consumers would benefit from a competitive supply of goods and services. If government did not spend resources monitoring mergers, consumers would save in the form of lower taxes.

3. Why has government recently started to deregulate the economy?
**KEY TERMS**

- **financing** The obtaining of funds, or money capital, for business expansion *(page 263)*
- **cost-benefit analysis** The process in which a business estimates the cost of an action and compares it with the benefits of that action *(page 265)*
- **revenues** Total money received from the sale of output *(page 265)*
- **profits** The money remaining after a business subtracts its costs from its revenues *(page 265)*

**DRAWING FROM EXPERIENCE**

Imagine that you have a job delivering pizzas. Sometimes a delivery is late because you have trouble finding the address. When this happens, the customer gets the pizza free and its cost is deducted from your pay. If you had a cell phone, you could call for directions when you cannot find a customer’s location. However, you would have to buy the phone and pay the monthly service charge. How do you find out if this idea will help or hurt you financially?

This section focuses on the financial considerations involved when a business successfully improves or expands its operations.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about how the cost of financing affects business expansion.

If the cost of financing is ________    →    fewer businesses will seek financing

If the cost of financing is ________    →    more businesses will seek financing

**READ TO LEARN**

- **Introduction** *(page 263)*

*Financing* is obtaining funds, or money capital. Businesses use other people’s savings and investments to finance expansion.

- **Turning Savings Into Investments** *(page 265)*

Being able to raise the money to start a new business or expand an existing one is an important part of the free enterprise system. One source of *financing*—that is, money capital—is a financial
institution, such as a bank. People save money by depositing it in a financial institution, such as a bank. The financial institution then makes these deposits available to businesses in the form of loans.

1. Where do financial institutions get the funds that they lend to customers?

110,

1. Before You Pursue Financing (page 265)

Other ways of financing the start or expansion of a business include using your own savings, borrowing money from family and friends, or selling shares of ownership in your company. However, being able to obtain financing does not necessarily mean that you should go ahead with your plans. Businesses make such decisions by conducting a cost-benefit analysis. This is a process in which you estimate the cost of an action and compare it with the benefits of that action. A cost-benefit analysis for a business has five steps:

1. Estimate the costs of the planned action.
2. Estimate the expected revenues, or total income from sales.
3. Calculate expected profits, or revenues minus costs (listed in Step 1).
4. Calculate how much it will cost to borrow funds for financing the costs.
5. If expected profits are greater than the cost of financing, the planned action may be appropriate.

In general, an action is worthwhile as long as the additional benefit at least equals the additional cost of the action.

2. Under what circumstance would buying new equipment to expand a business not be a good idea?

110,

1. Why People Are Willing to Finance Investment (page 266)

Businesses want to obtain financing so that they can expand and make more profit. The people who provide the money, even if they do so unintentionally, are also seeking rewards. For example, the person who deposits money in a savings account or a certificate of deposit (CD) is not doing so in order to finance business growth. Instead, he or she wants the interest earned on the account. People who intentionally finance a business may buy a corporate bond or stock that the business issues. Their reward is the interest the company pays on the bond or the dividend the company pays on the stock.
3. How do people who save money in financial institutions both reward themselves and help the growth of business?

[Instructor's note: Explain how savings benefit individuals and support business growth.]

4. How does the cost of financing affect the growth of the economy?

[Instructor's note: Describe the impact of financing costs on economic growth.]

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**Pursuing Investment Financing** *(page 267)*

In a free enterprise system, resources generally go where they will produce the highest expected value. Businesses compete for financial resources. If the cost of financing is high, only businesses that believe they can make high profits by expanding will want to pay these costs. If the cost of financing is low, more companies will decide that they can profitably expand. In general, the more convinced a business is that it will make high profits by expanding, the more it will be willing to finance the investment. A company may decide to sell stocks or bonds to obtain financing. It may also borrow money from financial institutions.
KEY TERMS

debt financing  Raising money for a business through borrowing (page 271)
short-term financing  Money borrowed by a business for any period of time less than a year (page 271)
intermediate-term financing  Money borrowed by a business for 1 to 10 years (page 272)
long-term financing  Money borrowed by a business for a period of more than 10 years (page 273)

DRAWING FROM EXPERIENCE

One of your classmates is starting a lawn care business. However, she needs money to purchase a power mower, riding mower, power trimmer, and leaf blower. If you will give her the money to get started, she will give you a one-third share of the profits in return. Or, you can lend her the money at a fixed interest rate. Which way of financing her business would be best for you?

This section focuses on how businesses decide on financing.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about examples of each type of debt financing.

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READ TO LEARN

- Three Kinds of Financing (page 271)

There are three categories of debt financing, or borrowing, that a company may use to obtain money for expansion:
Short-term financing is borrowing for any period of time that is less than a year. Businesses usually seek short-term financing to meet short-term needs. Short-term loans may be secured with collateral—something of value the borrower must give the lender if the borrower fails to repay the loan. However, most short-term loans are unsecured. The loan is guaranteed only by the borrower’s promise to repay. A special type of short-term loan is a line of credit. This is a preapproved sum of money that a business can borrow from until the loan reaches the maximum amount approved. Trade credit—which allows a business to buy goods without immediately paying for them—is another common type of short-term financing.

Intermediate-term financing is borrowing for a period of 1 to 10 years. It usually occurs when a company wants to buy something, such as a new building or equipment, that is too expensive to repay over a short term. Most intermediate-term loans are secured by collateral. If that collateral is the company’s building, the loan is called a mortgage. Another type of intermediate-term financing is leasing, or renting, your building or equipment instead of buying it.

Long-term financing is borrowing for a period of more than 10 years. This type of financing is used for major purchases, such as building and equipping a new factory. Companies often obtain long-term financing by selling stock or bonds. Bonds pay buyers a set rate of interest over a set period of time. Stocks pay dividends that are usually based on the company’s performance. Raising money by selling stock is called equity financing because part of the ownership, or equity, of the company is being sold.

1. What differences are there in the way that businesses use short-term, intermediate-term, and long-term financing?

Choosing the Right Financing (page 274)

Businesses try to acquire capital by obtaining the least expensive financing. Whether a company takes out a loan, issues stock, or sells bonds to raise money, depends on four factors:

A. Interest Costs. When interest rates are high, businesses hesitate to take out loans. They may delay expansion, or they may take out a series of short-term loans, hoping that interest rates will fall. The same concerns apply to selling bonds, because companies do not want to pay high interest rates to buyers.

B. Company’s Financial Condition. A company with sales and profits that are stable can take on more debt safely, if its current debt is not too large.

C. Market Climate. If economic growth is slow, companies may want to issue bonds rather than stock in order to raise financing. This is because buyers may prefer the fixed interest rate of a bond over the uncertain dividend that most stocks would pay.

D. Control of the Company. Holders of common stock have voting rights in company elections. Buyers of bonds have no voting rights. When debating issues of financing, financial managers may have to gain approval from the owners of the common stock.

2. Why would a company evaluate its financial condition when deciding whether to sell bonds?
**THE PRODUCTION PROCESS**

**KEY TERMS**

- **production** The process of changing resources into goods that satisfy the needs and wants of individuals and businesses (page 277)
- **consumer goods** Goods that are sold to the public to be used as they are (page 277)
- **mechanization** The process that combines the labor of people and machines (page 280)
- **assembly line** System in which the good being produced moves on a conveyor belt past workers, who perform individual tasks on it (page 280)
- **division of labor** System in which a job is broken down into small tasks with a different worker performing each task (page 280)
- **automation** System in which machines work according to people’s instructions (page 280)
- **robotics** System in which computers control the production machines (page 281)

**DRAWING FROM EXPERIENCE**

Suppose that you were put in charge of decorating the school gym for the homecoming dance. How would you approach this project? How would you make sure that you purchase enough of everything you need but not more than you can use? How would you organize your helpers? Finally, how would you schedule these tasks to make sure the gym is decorated in time?

This section focuses on the methods of production and all the steps in the production process.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries. Rank the methods of production from the one that uses the least technology to the one that uses the most.
READ TO LEARN

**Steps in Production Operations** (page 277)

*Production*—is the process of changing resources into goods that satisfy the wants and needs of individuals and businesses. Consumer goods are goods sold to the public for use directly as they are. Capital goods are goods used to make other goods. A car is an example of a consumer good. A machine that helps make the car is a capital good.

Actually making the good is only one step in the production process. Other steps are product design (discussed in Chapter 11), planning, purchasing, inventory control, and quality control.

*Planning*—includes choosing a location for the business and scheduling production. The ideal location is one that is near a satisfactory supply of labor, a source of raw materials, and a good market for the product. Good transportation facilities, such as highways or railroads, are perhaps most important. They help the company to receive its raw materials and get its products to market. Scheduling involves coordinating the timing and use of labor, machinery, and materials for each step in the production process so that it runs smoothly.

*Purchasing*—involves obtaining the raw materials, machinery, office supplies, and other goods that the company needs to operate.

*Quality Control*—involves checking the quality of the goods produced to make sure they meet company or industry standards or government regulations. These standards might include freshness, strength, proper design, safety, and workmanship.

*Inventory Control*—Companies do not want to run out of the materials they use in making their products. However, too large a supply, or inventory, increases the costs of storing and insuring the materials. These issues also apply to inventories of the goods the company produces.

1. How are planning and inventory control related?

**Technology and Production** (page 280)

Technology is the use of science to develop new products and new ways to produce and distribute goods and services. The advances in technology that have most affected production are mechanization, the assembly line, division of labor, automation, and robotics. *Mechanization* combines the labor of people with the use of power-driven machines. Workers are able to produce more product as a result. A special type of mechanization is the *assembly line*. This is a production system in which the good being produced moves on a conveyor belt from worker to worker. Each worker performs a specific task. Assembly line production is made possible by the *division of labor*—a system that breaks down a job into small tasks.

Mechanization combines the labor of people and machines. In *automation*, machines do all the work and the people merely oversee them. *Robotics* is an even more sophisticated system in which the entire process is controlled by computers.

2. Why is an automated teller machine (ATM) an example of automation and not of robotics?
THE CHANGING ROLE OF MARKETING

KEY TERMS

marketing All the activities needed to move goods and services from the producer to the consumer (page 289)
consumer sovereignty The role of the consumer in determining the types of goods and services produced (page 290)
utility The ability of a product to satisfy customer wants (page 290)
market research Gathering and analyzing data about the types of goods and services that people want (page 292)
market survey Survey in which researchers gather information about possible users of a product (page 293)
test marketing Offering a product for sale in a small area for a limited period of time to see how well it sells before offering it in the larger market (page 293)

DRAWING FROM EXPERIENCE

When you bought a product recently did you notice the questionnaire that was part of the product’s warranty card? This was the form that asked you about your age, gender, education level, why you bought the product, and so on. Did you fill out and return the card? The manufacturer was not merely being nosy by asking such questions. It was trying to find out what kinds of people buy its products.

This section focuses on how the practice of marketing developed and how companies find out what consumers want in the products they buy.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the four types of utility as you complete the diagram.

- Utility
  - converting crude oil to gasoline
- Utility
  - locating a gas station on a busy corner
- Utility
  - opening a 24-hour supermarket
- Utility
  - your pride in something you own

Examples of Utility
READ TO LEARN

**Introduction** (page 289)

Marketing involves all the activities needed to move goods and services from the producer to the consumer.

**The Development of Marketing** (page 289)

In the early 1900s producers began to advertise beyond their local markets to sell all the goods that technology enabled them to produce. This gave consumers more choices. In the 1920s producers began to compare their product to their competitors’ products. Such advertising helped consumers choose the product that best met their needs. In the 1950s producers began to create demand. Advertising tried to convince consumers that they needed a producer’s product in order to have a desired lifestyle.

By the 1980s, advertising tried to get consumers to identify with a person in the ad rather than the product itself. This is because competitors’ products were so similar. Companies also had begun to research what consumers wanted. This practice showed that consumer sovereignty—the idea that the consumer is ruler of the market—had returned to marketing. In the 1990s the growth of the Internet allowed small firms to advertise inexpensively. Large firms that produced for the general public faced competition from small companies that could provide products to meet the specific wants of small groups and individuals.

Today the purpose of marketing is to convince consumers that a certain product has the utility they want. Utility is the ability of a product to satisfy customer wants. There are four types of utility:

1. **Form utility** is the conversion of raw materials to a desired product, such as refining crude oil into gasoline.
2. **Place utility** is having a product available where consumers want to buy it, such as locating a gas station on a busy corner.
3. **Time utility** is having a product available when consumers want to buy it. An example is an all-night restaurant.
4. **Ownership utility** is the satisfaction a consumer receives simply from owning the product.

1. Why was marketing in the 1950s not a good example of consumer sovereignty?

**Market Research** (page 291)

Through market research a company gathers and analyzes information about the types of goods and services people want. Early market research is conducted to test ideas for new products or actual sample products. This helps producers find out if consumers will want the product and what types of consumers are the most likely buyers. Other market research tests consumer response after the product is available. It may determine if advertising is attracting the intended types of consumers, or what could be done to increase sales.
The first step in any market research is the market survey to gather information about the users or potential users of a product. Market surveys typically involve a series of carefully worded questions. They can be printed questionnaires, individual interviews, or group discussions called focus groups.

Before a company begins to sell a product, researchers may test-market it. In test marketing the product is sold in a small area or areas for a short period. This allows researchers to observe consumer response to the product. Sometimes, test marketing results will cause a company to change a new product or even to not offer it for sale.

2. How could test marketing help a business decide how much to sell a product for?
THE MARKETING MIX

KEY TERMS

price leadership  Practice of setting prices close to those charged by other companies selling a similar product (page 298)
penetration pricing  Setting a low price for a new product to attract consumers away from an established product (page 298)
promotion  Use of advertising to inform consumers that a new or improved product is available and to convince them to buy it (page 299)
direct-mail advertising  Using a mailer that includes a description of the product and an order form (page 299)
product life cycle  Series of stages that a product goes through from its introduction to its withdrawal from the market (page 300)

DRAWING FROM EXPERIENCE

Suppose that you want to buy a new sweater to add to your wardrobe. Where will you look in shopping for a sweater that appeals to you? Will you go to a department store? a discount store? a specialty shop? How important a factor is price in deciding what sweater to buy? Producers try to predict your answers to such questions as they make decisions about how to place, price, and promote their goods and services.

This section focuses on the “four Ps” of a marketing strategy or plan: product, price, place, and promotion.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about examples of the four elements—the “four Ps”—of marketing.

<table>
<thead>
<tr>
<th>Element</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>penetration pricing</td>
<td></td>
</tr>
<tr>
<td>packaging</td>
<td></td>
</tr>
<tr>
<td>free sample</td>
<td></td>
</tr>
<tr>
<td>department store</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

Introduction (page 296)

The “four Ps” of marketing are product, price, place, and promotion.

Product (page 296)

Market research helps companies decide what products and accompanying services to offer, how to package goods, and what kind of product identification to use. A warranty is the most common service offered with manufactured goods. Packaging is designed to attract consumers to buy the product. The purpose of product identification is to get consumers to remember and take a look at a product. This might be done through a celebrity endorsement, a logo, or certain colors on the package.

1. Why is packaging such an important part of the marketing mix?

Price (page 298)

In setting a product’s price, a company must consider its costs, the profit it wants to make, and the price’s effect in attracting possible buyers. Companies often set prices according to what other companies are charging for a similar product, a practice known as price leadership. Sometimes a company will introduce a product by offering it at a lower price than competitors’ established products. This strategy is known as penetration pricing.

2. If a company prices its product higher than similar products of its competitors, one of two things is likely to occur. Identify these two possibilities.

Place (page 299)

Where the product should be sold is another marketing decision. Choices can include through the mail, by telephone, door-to-door, over the Internet, and in various types of stores. Past experience with similar products helps in making this decision.

3. What advantage might there be for a jeans manufacturer to sell its goods in a department store? In a specialty store?

Promotion (page 299)

Promotion is the use of advertising to inform consumers that a new or improved product is available and to convince them to buy it. Methods include advertising in newspapers and magazines
and on television and radio. **Direct-mail advertising** sends people a description of the good or service and an order form for it. Other promotional methods include free samples, money-off coupons, and rebates.

4. Why would a money-off coupon be a good way to promote a new product?

---

**Product Life Cycle** *(page 300)*

A *product life cycle* is a series of stages that a product goes through from its introduction to its withdrawal from the market. The way a product is promoted may depend on its stage in the life cycle. Companies often try to extend the life of old products by changing the way goods or their packaging looks. Marketers may try to find new uses for a product and then change the focus of its advertising.

5. Why would a new use for an old product keep a company from withdrawing it?
DISTRIBUTION CHANNELS

KEY TERMS

channels of distribution  Routes by which goods are moved from producers to consumers (page 302)
wholesalers  Businesses that purchase large quantities of goods from producers for resale to other businesses (page 303)
retailers  Businesses that sell consumer goods directly to the public (page 303)
e-commerce  Conducting business transactions over the World Wide Web and other computer networks (page 303)

DRAWING FROM EXPERIENCE

What are your shopping habits? Do you buy things from catalogs? What about from those “infomercial” programs or shopping networks that you see on TV? What types of stores do you patronize? Do you enjoy looking for bargains at club warehouses and factory outlets? Goods reach consumers in a number of ways. You likely use several of these distribution channels to satisfy your wants and needs.

This section focuses on channels of distribution, or the routes by which goods are moved.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about how goods traditionally reach consumers.

The Traditional Channel of Distribution

Producer  →  ______  →  ______  →  Consumer

READ TO LEARN

Wholesalers and Retailers (page 302)

Some consumer goods, such as automobiles, are normally sold by the producer directly to a retailer, who then sells them to consumers. Other consumer goods, such as clothing, move from the producer through a wholesaler to a retailer, and then to the consumer. With each transaction the price of the goods increases. Few goods go directly from the producer to the consumer.

A wholesaler is a business that buys large amounts of goods from producers and then resells them to other businesses, such as stores. Some wholesalers buy capital goods or raw materials and resell them to manufacturers. Various kinds of wholesalers exist, depending on who stores and delivers the purchases and how they are paid for.
Retailers are businesses that sell consumer goods directly to the public. They traditionally sell products from a store. In recent years, however, many retailers have established sites on the World Wide Web from which they sell their goods as part of what is called e-commerce. Some e-commerce retailers have no physical store at all. They do all their selling from their Web site.

1. How do the customers of a wholesaler and a retailer differ?

Storage and Transportation (page 304)

Part of the distribution process involves storing goods for future sales. Producers, wholesalers, and retailers all may perform this function. Many retailers keep a two- or three-month supply on hand to meet current sales needs. Transportation involves the actual movement of goods from producers or other sellers to buyers. The type, size, and weight of the good are factors in deciding the method used to transport it. For example, speed would be important in getting fresh fruit to a food plant. The cost of different kinds of transportation helps companies decide how to ship items.

2. Why would ships or trains be a better choice than airplanes for moving wheat?

Distribution Channels (page 304)

Direct marketing and club warehouse stores are two distribution channels that have grown rapidly in recent years. The stores usually are large warehouse-type buildings that offer limited choices of goods. Because they buy huge quantities of goods, they get low prices from manufacturers. This allows them to resell the goods for less than other retailers. Businesses involved in direct marketing sell products mainly through catalogs and over the Internet. However, some direct marketers offer products through “space ads” in newspapers and magazines.

3. What business cost would a traditional retailer have that a direct marketer would not?
Americans at Work

**Key Terms**

**Civilian Labor Force** Total number of people 16 years old or older who are employed or seeking work (page 313)

**Blue-collar Workers** Category of workers employed in crafts, manufacturing, and nonfarm labor (page 315)

**White-collar Workers** Category of workers employed in offices, sales, or professional positions (page 315)

**Service Workers** Category of workers who provide services directly to individuals (page 315)

**Unskilled Workers** People whose jobs require no specialized training (page 316)

**Semiskilled Workers** People whose jobs require some training, often using modern technology (page 316)

**Skilled Workers** People who have learned a trade or craft either through a vocational school or as an apprentice to an experienced worker (page 316)

**Professionals** Highly educated individuals with college degrees and usually additional education or training (page 316)

**Minimum Wage Law** Federal law that sets the lowest hourly wage that may be paid to certain types of workers (page 319)

**Drawing from Experience**

Did you realize that your school is like a miniature labor force? Every day white-collar, blue-collar, professional, service, skilled, semiskilled, and unskilled employees are at work around you. The teachers, cooks, custodians, and office staff of your school mirror the way that work is divided throughout the American economy.

This section focuses on how workers are classified, how wages are determined, and why employers must pay more to get and keep good workers.

**Organizing Your Thoughts**

Use the chart below to help you take notes as you read the summaries that follow. Think about how supply and demand in various types of jobs affects what they pay.

<table>
<thead>
<tr>
<th>Type of Job</th>
<th>Worker Supply: High or Low?</th>
<th>Employer Demand: High or Low?</th>
<th>Wages: High or Low?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Dangerous</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Desirable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Skilled</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Unskilled</td>
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</tr>
</tbody>
</table>
READ TO LEARN

The Civilian Labor Force (page 313)

The civilian labor force is the total number of people 16 years old or older who are either employed or are actively seeking work. It does not include people who are not able to work, people who are in the military, or people who are not looking for a paying job.

1. Why would full-time students not be included in the civilian labor force?

Categories of Workers (page 314)

Workers can be classified in several ways. One way is by the type of work they do. The largest group in the labor force is white-collar workers. This group includes office workers, salespeople, and highly trained people such as engineers. Blue-collar workers are people who work at a craft or a manufacturing job or perform nonfarm labor. In recent years, the economy has shifted gradually from blue-collar jobs to jobs in the service sector. Service workers are people, such as cooks and health-care aides, who provide services directly to individuals.

Another way workers may be classified is by the education or training their jobs require. Unskilled workers perform jobs that require no specialized training. Waiters and waitresses are examples of unskilled workers. Semiskilled workers are people whose jobs require some specialized training, often involving modern technology. Nurse’s aides are an example of semiskilled workers. A skilled worker has a trade or craft. This skill may have been learned at a vocational school or as an apprentice to an experienced worker. A police officer, for example, is considered a skilled worker. Professionals are people with college degrees and usually additional education or training. However, the line between professional workers and technical workers has become increasingly vague. Technicians today often require considerable training in difficult jobs.

2. Classify the following jobs in each of the systems described above: (a) hair stylist; (b) custodian; (c) dentist; (d) receptionist.

Supply and Demand in the Labor Market (page 316)

Like other markets, the labor market is affected by supply and demand. Workers who offer their services are the supply. The demand comes from employers who need workers. Three factors affect how supply and demand determine the “price” of labor—that is, wages. These factors are skill, type of job, and location.

Skill is the ability a person brings to the job. It may come from talent, training, experience, or initiative. Wages for such workers are high because there is high employer demand for them and a relatively small supply. Initiative is related to skill and wages because it affects productivity. A highly productive worker who is underpaid will likely be lured away by a higher-paying employer.
Unpleasant or dangerous jobs often pay more than other jobs at the same skill level. On the other hand, the prestige or desirability of some jobs is so high that many people want them. The large supply of workers keeps wages down. Location also can affect labor supply. If workers are scarce in an area, employers may have to pay high wages to attract them there.

Two factors limit the operation of supply and demand in setting wages. These are the wage negotiations of labor unions with employers and the federal minimum wage law. This law sets the lowest hourly rate that can be paid to certain types of workers.

3. Why would a dangerous job pay more than another job at the same skill level?
ORGANIZED LABOR

KEY TERMS

labor union  Association of workers organized to improve wages and working conditions for its members (page 321)
strike  Deliberate work stoppage by workers to force an employer to give in to their demands (page 323)
craft union  Union made up of skilled workers in a specific trade or industry (page 323)
industrial union  Union made up of all workers in an industry regardless of their job or skill level (page 324)
local union  Members of a union in a particular factory, company, or geographic area (page 324)
closed shop  Company in which only union members may be hired (page 324)
union shop  Company that requires new employees to join a union after a specific period of time (page 324)
agency shop  Company in which employees are not required to join a union, but must pay union dues (page 324)
right-to-work laws  State laws forbidding unions from forcing workers to join and pay union dues (page 325)

DRAWING FROM EXPERIENCE

You might expect that service employees, like the cooks in your cafeteria, could be members of a labor union. However, would it surprise you that your teachers may working under a union contract with your school system? The National Education Association (NEA) and the American Federation of Teachers (AFT) are two of the nation’s largest and most powerful labor unions. This section focuses on the organization and operation of labor unions.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about the relationship between a company and its workers under a union contract.

<table>
<thead>
<tr>
<th>Types of Union Organization</th>
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<tbody>
<tr>
<td>___________________________ shop</td>
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<td>___________________________ shop</td>
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<td>___________________________ shop</td>
</tr>
</tbody>
</table>
American workers formed labor unions to have some control over wages and working conditions. A labor union is an association of workers organized to improve wages and working conditions. Unions are based on the idea that workers as a group will have more influence on management than will individual workers acting alone. Management refers to those in charge of a company—the executives and managers.

1. Upon what idea are unions based?

Working conditions in the 1800s were very different from what they are today. The workweek was long, wages were low, and machinery was sometimes dangerous to operate. Producers fired workers when business slumped and hired new ones when business improved. Unemployment benefits, health insurance, sick leave, and paid vacations did not exist. Workers began to form associations called labor unions to force employers to improve these conditions. However, many businesses resisted by refusing to hire union members or deal with unions. Strikes—work stoppages by employees to force their employer to meet their demands—often ended in violence between strikers and police. Not until the 1930s did federal laws regulate relations between workers and employers.

Labor unions are generally of two types—craft unions and industrial unions. A craft union is made up of skilled workers in a specific trade or industry. For many years craft unions dominated the labor movement. They formed an organization called the American Federation of Labor (AFL). An industrial union is made up of all workers in an industry regardless of their job or level of skills. In the 1930s, an organization of industrial unions was formed called the Congress of Industrial Organizations (CIO). The AFL and the CIO merged in the 1950s. Today, most labor unions are members of the AFL-CIO.

2. What is the difference between an industrial union and a craft union?

Organized labor operates at three levels—the local union, the national or international union, and the federation. A local union consists of members of the national (or international) union who work in a particular factory, company, or geographic area. The local deals with a company by negotiating a contract and making sure that the contract’s terms are kept. Much of the relationship between the company and the workers is governed by the contract. At one time, some contracts required a closed shop—that is, the company could hire only union members. Today, closed shops are illegal. However, union shops are not. In a union shop, all new employees must
join the union within a specified time after they are hired. In an agency shop, employees must pay union dues whether they belong to the union or not.

Union supporters say that all employees should pay dues because they all benefit from the contract the union negotiates with the company. Other people say that workers should not be required to support unions. Several states have passed right-to-work laws. These laws allow workers to not join the union but receive the same company benefits as union members.

Local unions are members of national or international unions. These organizations are the craft or industrial unions that represent the locals nationwide. They send in people to help workers organize a local union or to help in contract negotiations with their employer. In some industries, the national union negotiates the contract for the entire industry. Most national unions are members of a labor federation. More than 65 national unions are members of the AFL-CIO.

3. How have right-to-work laws weakened the union movement?
COLLECTIVE BARGAINING

KEY TERMS

**collective bargaining** Process by which unions and employers negotiate the conditions of employment (page 328)

**mediation** Process in which a neutral third party steps into negotiations and tries to get both sides to reach agreement (page 329)

**cost-of-living adjustment (COLA)** Provision providing an additional wage increase if the general prices rise beyond a specified level during the year (page 329)

**arbitration** Process in which negotiating parties submit issues they cannot agree on to a third party for a final decision (page 329)

**picketing** Activity in which striking workers carry signs outside their workplace that state their disagreement with their employer (page 329)

**boycott** Economic pressure exerted on a company by refusing to purchase its goods or services (page 331)

**lockout** Process in which an employer prevents workers from working until they agree to a new contract (page 331)

**injunction** Court order that prohibits some activity (page 332)

DRAWING FROM EXPERIENCE

Suppose that students at your school wanted to change some school policy. How likely would achieving the change be if a few students, speaking for themselves, went to the principal individually and asked for the change? Do you think the request would get more attention if just one student went to principal, but with a petition signed by the entire student body?

This section focuses on how employers and unions negotiate the conditions of workers’ employment.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the steps that union and employers take to reach agreement.
READ TO LEARN

Negotiations (page 329)

The process that unions and employers use to reach agreement on a work contract is called **collective bargaining**. Negotiations usually cover a wide range of issues. These may include:

(a) wages; (b) fringe benefits such as health insurance, vacations, or a retirement plan; (c) work hours and overtime pay; (d) working conditions, such as job safety and a pleasant work environment; (e) job security, including procedures the employer must follow when laying off workers; and (f) grievance procedures. These are rules that each side must follow to settle a complaint that the other side is not living up to the terms of the contract. Some contracts call for an extra wage increase if general prices in the economy rise beyond a certain level. This is called a **cost-of-living adjustment**, or COLA.

The key to collective bargaining is compromise. The employer wants to keep wages, benefits, and other labor costs low in order to remain competitive in the market. The union wants to increase wages and benefits for its members. If negotiations break down, both sides may agree to **mediation**. This is when a neutral person listens to the position of each side and suggests possible solutions. If mediation fails, the union and employer may go to **arbitration**. In this step, they submit the issues they cannot agree on to a neutral person, who makes the final decision. Both sides agree in advance to accept the arbitrator's decision, even if one or both are not happy with it.

1. What similarities are there in the mediation and arbitration processes? What differences are there?

Strikes and Management (page 329)

Sometimes contract negotiations break down. When this happens a strike may result. During a strike, union members may carry signs outside their workplace that state their disagreement with the company. This action is called **picketing**. It is meant to discourage other workers from entering the workplace and to build public support for the strike. Striking unions may increase the economic pressure on the company through a **boycott**. In a boycott, the union asks the public to not buy the company's products.

Employers also have weapons they can use when negotiations break down. One is a **lockout**, in which the employer prevents the employees from working until they have agreed to a new contract. Sometimes a company will bring in strikebreakers. These are people who are willing to cross a picket line and work on the company's terms during a strike. An employer may also ask for a court order, called an injunction, to keep a strike from occurring or to force striking employees back to work. However, most strikes are settled voluntarily, as the sides resume negotiating and work out an agreement.
2. What economic pressure does a strike put on the company to reach an agreement with the union?

Decline of Unions (page 332)

Supporters claim that the union movement has resulted in better wages and working conditions for all workers. They also claim that unions have brought more job security, order, and fairness to the workplace. Opponents of unions claim that wage increases have resulted in higher prices for consumers. They also claim that unions have decreased productivity by slowing the introduction of labor-saving technology.

Because wages and working conditions have improved, workers today often see little to gain by joining a union. In addition, the economy is changing. The number of blue-collar jobs is declining due to automation. For these and other reasons, union membership has also been declining.

3. Why might productivity be affected by a union’s emphasis on job security?
For use with textbook pages 343–348

NATIONAL INCOME ACCOUNTING

KEY TERMS

*national income accounting* Measures the economy’s output and income to help judge its overall performance (page 343)

*gross domestic product (GDP)* Reports the combined dollar value of all final goods and services produced in a nation during a single year (page 344)

*net exports* This figure is found by subtracting the value of goods bought from other countries from the amount of goods sold to other countries (page 346)

*depreciation* Loss of value in durable and capital goods caused by wear and tear (page 347)

*net domestic product (NDP)* Reports a nation’s total output (GDP) minus the total value lost through depreciation on machines and equipment (page 347)

*national income (NI)* Total amount of income earned by everyone in the economy (page 347)

*personal income (PI)* Total income received by individuals before paying personal taxes (page 348)

*transfer payments* Welfare and other supplementary payments made by a state or federal government to individuals. These payments include unemployment compensation, Social Security, and Medicaid (page 348)

*disposable personal income (DI)* Amount of income remaining for people to spend or save after all taxes are paid (page 348)

DRAWING FROM EXPERIENCE

Have you ever compared your standard of living with a friend? How did you measure economic success?

In this section, you will learn about methods of measuring the performance of the economy as a whole.
Use the diagram below to help you take notes as you read the summaries that follow. Think about how economic performance is measured across the entire economy.

**National Income Accounting**

1. GDP
2. NDP
3. NI
4. PI
5. DI

Add:
1. _________ + 2. _________ + 3. _________ + 4. _________ = GDP

minus

minus

minus

minus

plus

minus

minus

**READ TO LEARN**

- **National Income Accounting** *(page 343)*

National income accounting helps to judge the economy’s health. It measures the amount of goods and services produced in a nation as well as the amount of income people have to spend during a given year. This technique also assesses the interaction of consumers, businesses, and the government. Five statistics are collected to permit this type of analysis.

1. Gross Domestic Product (GDP)
2. Net Domestic Product (NDP)
3. National Income (NI)
4. Personal Income (PI)
5. Disposable Personal Income (DI)

1. What does national income accounting do?
Measuring GDP (page 344)

Gross Domestic Product, also known as GDP, is the broadest measure of the economy’s size. GDP is the total dollar value of all final goods and services produced in a nation during a single year. It avoids double counting by measuring only the value of final goods. Because it gauges production in one given year, GDP only counts new goods. As a measurement tool, GDP has two major weaknesses. First, some statistics can only be estimated. Second, GDP measures quantity without accounting for quality. GDP is calculated by adding together spending in four main categories.

1. The Consumer Sector (C) = goods or services purchased for direct use
2. Investment (I) = business purchases used to produce other goods and the cost of maintaining inventories
3. Government Purchases (G)
4. Net Exports (X) = the amount of goods sold to other countries minus the amount of goods purchased from other countries

Gross Domestic Product (GDP) can be expressed by the following formula: GDP = C + I + G + X

2. What are the four main categories of spending that are added together to calculate GDP?

Net Domestic Product (NDP) (page 347)

Net Domestic Product, or NDP, measures the depreciation of durable goods, such as automobiles and refrigerators. Depreciation is the total loss of value due to wear and tear. It is calculated by subtracting depreciation from the Gross Domestic Product.

3. What does net domestic product measure?

Measurements of Income (page 347)

Measuring income describes how much money is available to be spent by business and individuals. Three measurements describe the money available to be spent by businesses or individuals.

1. National Income (NI) is the total amount of income earned by everyone in the economy. It is the sum of five categories of income.
   a. wages and salaries
   b. income of self-employed individuals
   c. rental income
   d. corporate profits
   e. interest on savings and investments

National income equals NDP minus indirect business taxes including sales and property taxes and license fees.
2. **Personal Income (PI)** is the total income received by individuals before paying personal taxes. PI equals NI minus income that is not available for individuals to spend plus transfer payments. Items subtracted include corporate income taxes, profits reinvested in a business, and Social Security contributions made by employers. Transfer payments added include welfare payments and other assistance payments, such as unemployment compensation, Social Security, and Medicaid. Transfer payments are income which individuals receive even though they are not exchanged for a current productive activity.

3. **Disposable Personal Income (DI)** is the income that people have left after taxes, including Social Security contributions. It is an important indicator of the economy's health because it measures the actual amount that a person has available to save and spend. DI equals PI minus personal taxes.

4. How do you calculate national income, personal income, and disposable income?
CORRECTING STATISTICS FOR INFLATION

KEY TERMS

inflation  A prolonged rise in the general prices of goods and services (page 350)
purchasing power  The value of money as determined by measuring the amount of real goods and services that money can purchase (page 351)
deflation  A lengthy decline in the general price of goods and services (page 351)
consumer price index (CPI)  Measures the change in price over time for a specific group of goods and services used by the average household (page 351)
market basket  A group of goods and services used to compile the consumer price index (page 352)
base year  In a series of statistics, this is the year used as a point of comparison (page 352)
producer price index (PPI)  Measures the change in price over time that producers charge for their goods and services (page 353)
GDP price deflator  A price index that permits the comparison of one year’s economic performance to another by removing the impact of inflation (page 353)
real GDP  GDP that has been adjusted for inflation by applying the price deflator (page 353)

DRAWING FROM EXPERIENCE

How much did you pay for your favorite good, such as a video game or music CD, last year? Did you pay the same price for similar goods this year? If your income stayed the same as last year, could you buy more or less of your favorite good? Economists ask similar questions when they try to judge the impact of inflation on your purchasing power.

In this section, you will learn about how economists measure inflation.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about how inflation affects the current dollar value of GDP as well as your ability to purchase goods and services.

<table>
<thead>
<tr>
<th>TERMS</th>
<th>DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation</td>
<td></td>
</tr>
<tr>
<td>CPI</td>
<td></td>
</tr>
<tr>
<td>PPI</td>
<td></td>
</tr>
<tr>
<td>GDP Price Deflator</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

Introduction (page 350)

*Inflation*, a rise in the general price level of goods and services, skews GDP figures.

**The Purchasing Power of Money** (page 351)

When inflation occurs, the price of goods and services rises. This means that the *purchasing power* of a dollar decreases. Purchasing power is the amount of real goods that a dollar can buy. If your income stays the same, but the prices of most goods go up, your purchasing power falls. Therefore, inflation also can be defined as a decline in the purchasing power of money. Inflation causes GDP figures to rise without any increase in output. *Deflation*, a prolonged decline in the general price level, also affects the dollar value of GDP, but deflation rarely happens.

1. When inflation occurs, does the purchasing power of a dollar increase or decrease?

**Measures of Inflation** (page 351)

Because prices in different areas of the economy rise at different rates, the government measures inflation in three common ways.

1. The *consumer price index (CPI)* measures the change in price of a specific group of goods and services that the average household uses. This group of goods and services is called a market basket. About every ten years the *market basket* is updated to include new products or services that reflect consumer spending. These prices are compared to a *base year*. The Bureau of Labor Statistics (BLS) currently uses the average of prices for the period from 1982 to 1984. These base prices are given a value of 100. CPI numbers for future years indicate the percent increase from the base year.

2. The *producer price index (PPI)* measures the average change in prices that producers charge their customers. It includes prices paid by producers buying raw materials for further processing and prices paid by wholesalers who sell to retailers or directly to customers. PPI measures prices in the three general areas of mining, manufacturing, and agriculture. Producer prices usually increase before the CPI. Eventually, consumers will pay for the rising prices associated with production.

3. The *GDP price deflator* allows economists to remove the effects of inflation. When the price deflator is applied to GDP, the new figure is called real GDP. *Real GDP* allows for the comparison of overall economic performance between different years.

Economists and policy makers know that these indexes have two major flaws. Price indexes do not always measure real change because they cannot account fully for changes in quality. Indexes do not measure changes in consumption patterns, such as reduced purchasing or consumption of substitute goods that are not part of the market basket.

2. What is measured by the consumer price index and the producer price index?
**KEY TERMS**

- **aggregates**: Sums of all the individual parts in the economy (page 356)
- **aggregate demand**: The total quantity of goods and services in the entire economy that all people will demand at any single time (page 356)
- **aggregate demand curve**: A graphed line showing the relationship between the aggregate quantity demanded and the average of all prices as measured by the implicit GDP price deflator (page 357)
- **aggregate supply**: Real domestic output of producers based on the rise and fall of the price level (page 358)
- **aggregate supply curve**: A graphed line showing the relationship between the aggregate quantity supplied and the average of all prices as measured by the implicit GDP price deflator (page 358)

**DRAWING FROM EXPERIENCE**

Have you ever wanted to buy something that was expensive? Did you wait until the price came down before you bought it? Have you ever sold something? Were you more likely to sell something when offered a higher price?

This section explains the effect of changes in the price level on aggregate supply and demand.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about the relationship between aggregate supply, aggregate demand, and the price level.

<table>
<thead>
<tr>
<th>Change in Price</th>
<th>Effect on Aggregate Demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>If price level increases</td>
<td>then aggregate demand ________</td>
</tr>
<tr>
<td>If price level decreases</td>
<td>then aggregate demand ________</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Change in Price</th>
<th>Effect on Aggregate Supply</th>
</tr>
</thead>
<tbody>
<tr>
<td>If price level increases</td>
<td>then aggregate supply ________</td>
</tr>
<tr>
<td>If price level decreases</td>
<td>then aggregate supply ________</td>
</tr>
</tbody>
</table>
Economists are interested in the demand by all consumers for all goods and services, and the supply by all producers of all goods and services. When we look at the economy as a whole in this way, we are looking at **aggregates**—the summing up of the individual parts of the economy.

**Aggregate Demand** (page 356)

Aggregate demand is the total quantity of all goods and services in the entire economy demanded by all people. Because there are millions of different prices for all products, aggregate demand is related to the average of all prices as measured by a price index. Aggregate demand can be based on real domestic output by using the GDP price deflator as the price index. Price level and aggregate demand share an inverse relationship. There are two reasons for this inverse relationship.

1. A dollar's purchasing power falls with inflation and rises with deflation. When the price level falls, the purchasing power of the money you are holding rises.
2. When the price level falls in the U.S., foreigners will want to buy our goods because they are relatively better deals.

A graph of aggregate demand is called an **aggregate demand curve**.

1. What is the relationship between aggregate demand and price level?

**Aggregate Supply** (page 358)

Aggregate supply is the total quantity of all goods and services offered for sale in the entire economy. As the price of a specific product goes up and the prices of all other goods remain the same, producers of that product find it profitable to make more of that specific product. If the price level goes up and wages stay the same, profits will rise. Producers will want to supply more products. Real domestic output will increase.

A graph of aggregate supply is called an **aggregate supply curve**.

2. What is the relationship between price level and aggregate supply? If the price level increases, does supply increase or decrease?

**Putting Aggregate Demand and Aggregate Supply Together** (page 358)

 Aggregate supply and aggregate demand can be compared to find the equilibrium price and quantity in the same way that supply and demand can be related. The equilibrium price level is located where the aggregate demand curve crosses the aggregate supply curve.

3. How is the equilibrium price level determined for aggregate supply and aggregate demand?
BUSINESS FLUCTUATIONS

KEY TERMS

**business fluctuations** Ups and downs in an economy *(page 360)*

**business cycle** Changes in the level of total output measured by real GDP *(page 360)*

**peak** A period in the business cycle where economic activity and prosperity are at their highest point *(page 360)*

**boom** Same as a “peak” *(page 360)*

**contraction** A point in the business cycle where economic activity is slowing down, leading to a trough *(page 360)*

**recession** A part of the business cycle in which the nation’s output, as measured by real GDP, does not grow for at least six months *(page 361)*

**depression** A major decrease in economic activity during which millions are out of work, many businesses fail, and the economy operates at far below capacity *(page 361)*

**trough** The lowest part of the business cycle. It is where a downward spiral of the economy levels off *(page 361)*

**expansion** A part of the business cycle in which economic activity slowly increases *(page 361)*

**recovery** Same as “expansion” *(page 361)*

DRAWING FROM EXPERIENCE

Have you ever thought about the four seasons of the year? How do you know what season it is? Do these indications of seasons occur where you live?

This section describes a model of the business cycle, which can be used to understand the ups and downs of economic growth.
ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the phases of the business cycle.

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READ TO LEARN

Model of the Business Cycle (page 360)

The phases of a business cycle begin with a period of growth leading to a period of prosperity known as a peak or boom. Eventually, the economy enters a period of contraction where GDP levels off and begins to decline. A recession occurs when real GDP does not grow for at least two quarters, or six months. If a recession deepens to the point where millions of people are out of work, many businesses fail, and the economy operates far below capacity, it becomes a depression. At some point, the downward trend levels off in a trough. A trough is the lowest point in the business cycle. It occurs when the decline in real GDP levels off and slowly begins to increase. An increase in GDP following a contraction is called an expansion or a recovery. If the recovery continues, the economy hits another peak and a new cycle begins.

1. Outline the business cycle described above beginning with a peak or boom and ending with a recovery.

---

Business cycle
In the real world, the cycles are not that regular, but peaks and troughs can be found. The stock market crash in October 1929 began a recession that eventually led to a depression. Heavy speculation drove stock prices to an all-time peak in September 1929. Stock prices fell through September and October 1929 until the stock market collapsed on October 28. The U.S. fell into a serious recession as factories shut down, businesses failed by the thousands, and millions of workers were laid off. Real GDP fell for the next few years turning the recession into a depression. A recovery began in 1937, but another downturn occurred. The economy recovered and entered a boom period following World War II. Some ups and downs occurred in the 1950s, but from 1960 through 1969 there were no recessions. In the 1970s and 1980s, the U.S. economy suffered recurring recessions, which ended in 1982. This downturn was the most serious since World War II. It was followed by a period of relative prosperity, except for the 1987 stock market crash.

2. Using the outline you constructed for activity number one in this section, match the events described above with the business cycle.
STUDY GUIDE

Chapter 13, Section 5

For use with textbook pages 364–367

C AUSES AND INDICATORS OF BUSINESS FLUCTUATIONS

KEY TERMS

innovations  New production techniques and inventions (page 365)

economic indicators  Statistics measuring variables in the economy (page 367)

leading indicators  Statistics showing what may happen in the economy (page 367)

coincident indicators  Economic indicators that change at the same time as change in overall business activity (page 367)

lagging indicators  Indicators that seem to trail changes in overall business activity (page 367)

DRAWING FROM EXPERIENCE

Think again about the seasons of a year. How do you know when the seasons are changing? Do all of these changes occur at the same time?

This section describes methods used by economists to predict changes in the business cycle.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the causes of business fluctuations.

READ TO LEARN

- Causes of Business Fluctuations (page 364)

Economists link business fluctuations to four main forces.

1. Business Investment  Some economists believe that business decisions are the key to business fluctuations. Individual companies anticipate changes in the business cycle by increasing or decreasing investments and inventories. Producers follow these trends by increasing or decreasing production. If many firms decide to increase investment and inventories, produc-
tion rises and the economy booms. If many firms decide to decrease investment and inventories, production decreases and the economy enters a recession. **Innovations** can have a similar effect on the economy. An innovation is an invention or a new production technique. When one firm adopts an innovation, other firms must imitate the product or production method to remain competitive. This causes a rise in investments, which eventually drops off because no additional capital is required to adopt the innovation.

2. **Government Activity** Government affects the business cycle by taxing and spending, as well as by exerting indirect control over the money supply.

3. **External Factors** Wars, availability of raw materials, new sources of raw materials, or the sudden loss of raw materials may raise or lower operating costs for certain industries.

4. **Psychological Factors** The prospects of peace or the discovery of new resources can lead to feelings of confidence and optimism. War and a shortage of materials can lead to pessimism. These factors contribute to consumer confidence and increased spending or the lack of confidence and more saving. Similar psychological factors influence the personal decisions made by business executives.

1. What are some of the potential causes of business fluctuations?

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**Economic Indicators (page 366)**

Economic indicators aid business and government decision makers in predicting future economic performance. GDP is not a good performance predictor because its measure is too broad. Economists rely on 78 economic indicators to predict future trends. Economic indicators are statistics measuring variables in the economy, such as stock prices and the dollar amount of loans being repaid. Indicators are not perfect predictors. Different indicators within a single group can move in opposite directions, and there is lead or lag time between a change in indicators and a change in the overall economy. There are three general categories of indicators.

1. **Leading Indicators** These statistics tend to point to the stage of the business cycle that the overall economy is entering.

2. **Coincident Indicators** These figures change at the same time as overall business activity changes.

3. **Lagging Indicators** Statistics in this category tend to change slower than overall business activity. They give economists clues as to the size and timing of all of the phases of the business cycle.

2. What do the three categories of economic indicators help to predict?
THE FUNCTIONS AND CHARACTERISTICS OF MONEY

KEY TERMS

money Anything customarily used as a medium of exchange, a unit of accounting, and a store of value (page 376)
middle of exchange Use of money in exchange for goods or services (page 376)
barter Exchange of goods and services for other goods and services (page 376)
unit of accounting Use of money as a yardstick for comparing the values of goods and services in relation to one another (page 376)
store of value Use of money to store purchasing power for later use (page 377)
commodity money Mediums of exchange such as cattle and gems that have value as a commodity or good aside from their value as money (page 378)
representative money Money that is backed by an item of value, such as gold or silver (page 378)
fiat money Money that has value because a government fiat, or order, has established it as acceptable for payment of debts (page 379)
legal tender Money that by law must be accepted for payment of public and private debts (page 379)

DRAWING FROM EXPERIENCE

Have you ever swapped trading cards with your friends? Did you think it was a fair trade? How did you determine the value of each card?

This section explains the concept of money. It also explains the different types of money.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about how you use money for different things, such as buying things, saving for later use, and making more money.
READ TO LEARN

The Functions of Money (page 375)

What is money? When you think about money, you probably think about bills, coins, and checks. But money also is defined by its functions, or the way in which it is used. Anything that is used as a medium of exchange, a unit of accounting, and a store of value is considered money.

A medium of exchange is something that a seller will accept in exchange for a good or service. For instance, people are paid for their work in money. Money is a medium of exchange. People then can use that money to purchase goods and services. Without money, people would have to barter for goods and services.

Barter is the exchange of goods and services for other goods and services. When you swap baseball trading cards with a friend, you are using a barter system. You have decided that the card you are trading is worth the card you are obtaining. For a barter system to work, each party must want exactly what the other person has to offer.

People use money to compare the value of goods and services in relation to one another. In this function, money is a unit of accounting. In the U.S., the base unit of value is the dollar. In Japan, it is the yen. Just as in the U.S. we use a yardstick to measure distance, we use dollars to measure the value of goods and services. This single unit of accounting makes it easier to compare prices on goods and services when you shop. A single unit of accounting also allows businesses and individuals to keep accurate financial records.

Money also functions as a store of value. A store of value is the use of money to put away for later use. A person uses money as a store of value when he or she deposits a paycheck in a checking account and then spends that money at different times on food, clothing, and other goods and services.

1. What is money?

Characteristics of Money (page 377)

Many different things have been used as money throughout history. Cattle, salt, gems, and animal hides have been used as money in the past. Some items are well-suited for being used as money. Others are not. Listed here are certain characteristics that any item used as money must have.

A. Durable Money must be able to withstand the wear and tear of going from person to person, business to business. For instance, coins last for years. Paper bills only last one year.

B. Portable Money should be easy to carry around.

C. Divisible Money should be easy to divide into smaller amounts so that smaller purchases can be made.
D. Stable in Value  If money is not stable in value, then it is not a good store of value. For instance, when there is extremely high inflation, the amount of purchasing power money has decreases. As a result, money in a person's savings account might not be worth as much as it was when he or she first put that money away.

E. Scarce  Money is valuable because it is scarce.

F. Accepted  Anything used as money must be accepted as a medium of exchange in payment for debts.

2. What characteristics must any item used as money have?

☐ Types of Money  (page 378)

There are several types of money. Money that has a value aside from its value as money is called commodity money. Cattle has been used as commodity money in the past. It was used for food and transportation as well as for money.

Money that is backed by a valuable item such as gold or silver is called representative money. Years ago, the U.S. used representative money. Banks would accept gold bars or silver ingots (called bullion) in exchange for paper money called banknotes. The banknotes were a promise to convert the paper back into gold or bullion on demand. This system did not always work because some banks went back on their promises to redeem the banknotes.

Money used in the U.S. today is called fiat money. Fiat money is money that has value because the government orders it so. Fiat money is called legal tender. Legal tender is money that must be accepted for payment of public and private debts. Another reason fiat money is accepted as payment for debts is because the people using it have faith that others will accept this money when it is used.

3. How does money become legal tender?
KEY TERMS

overdraft checking  Checking account that allows a customer to write a check for more money than exists in his or her account (page 384)
electronic funds transfer (EFT)  System of putting onto computers all the various banking functions that in the past were handled on paper (page 384)
automated teller machines (ATMs)  Units that allow consumers to do their banking without the help of a teller (page 385)

DRAWING FROM EXPERIENCE

In the United States, the FDIC (Federal Deposit Insurance Corporation) insures bank deposits. Would you feel confident about putting your money in a bank if your deposit was not insured? This section focuses on the history of banking and currency in the U.S. It also explains current banking practices and services.

ORGANIZING YOUR THOUGHTS

Use the time line below to help you take notes as you read through the summaries that follow. Fill in the significant events that occurred during the years listed. Think about what happened when there were no regulations on banks at certain times in American history.

<table>
<thead>
<tr>
<th>1791</th>
<th>1811</th>
<th>Civil War</th>
<th>1869</th>
<th>1913</th>
<th>1933</th>
</tr>
</thead>
<tbody>
<tr>
<td>1792</td>
<td>1816</td>
<td>1863–64</td>
<td>1907</td>
<td>1929</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

History of American Banking (page 381)

The history of American money is closely tied to the history of American banking. During the colonial period, England did not permit American colonists to print money or mint coins. As a result, bartering, or trading goods and services for other goods and services, was common. Also, some colonies developed commodity money, or goods that also are used as money.

During the Revolutionary War, the Continental Congress issued bills of credit, called Continentals, that could be used as money to pay debts. Unfortunately, too many of these notes were issued and they became worthless. After the war, the Constitution gave Congress the power to mint coins.

In 1791 Congress established the First Bank of the United States, which was a private business. Congress authorized the First Bank to regulate the activities of state-chartered banks.

In 1792 Congress passed the Coinage Act, which organized a mint for making currency and established the dollar as the basic unit of currency for the nation. The value of the dollar was fixed according to specific quantities of silver and gold.

In 1811 the First Bank of the United States was closed down. Without regulations dozens of banks started lending money and issuing banknotes. These banks did not always back up their deposits with enough gold and silver reserves. As a result, people lost confidence in these banks.

In 1816 Congress established the Second Bank of the United States. This bank made state banks limit lending and keep enough gold and silver in reserve to redeem their banknotes. Because of increasing opposition to the idea of having a strong national bank, President Andrew Jackson closed down the Second Bank in 1832.

Again, without a national bank regulating state banks, many new state banks opened up. These banks sometimes loaned money freely and other times did not loan much money at all. As a result, business activity and prices fluctuated widely during the period before the Civil War.

The United States issued greenbacks, or paper money, to help pay for the Civil War. This is the first time the U.S. government issued fiat money, or money that is ordered by the government to be accepted by everyone.

In 1863 and 1864, Congress passed the National Bank acts. These acts established a system of federally-chartered private banks, called national banks. The government also set up a safe, uniform currency by requiring that national banknotes be backed by government bonds.

In 1869 the nation shifted to a gold monetary standard. A gold standard is where the value of the dollar is backed by gold. Despite the new national banks system, there were still problems with money shortages. Financial panics occurred in 1873, 1884, 1893, and 1907.

In 1913 Congress established the Federal Reserve System. This became the nation’s central bank. It was established to regulate reserves in national banks, to make loans to member banks, and to control the growth of the money supply. The Federal Reserve System printed the paper currency that we use today, called Federal Reserve notes.

In 1929 The Great Depression began. Banks failed. Stocks and other investments lost their value. Bankrupt businesses and individuals were unable to repay their loans. In response to these events, Congress passed the Glass-Steagall Banking Act in June of 1933. This act established the Federal
Deposit Insurance Corporation (FDIC). The FDIC is the agency that insures individual deposits in banks today. This act also switched the nation from the gold standard to fiat money. These reforms allowed banks to enter a period of long-term stability. From the 1930s to the 1960s, very few banks failed.

In the late 1960s and early 1970s, Congress passed laws to protect consumers when dealing with financial institutions. During the 1980s banking was one of many deregulated industries. As a result, many savings and loan associations made risky loans, lost all their money reserves, and went bankrupt. The federal government had to pay their debts. Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act in 1989. The FDIC then took over regulating the savings and loan associations.

1. What happened in both 1811 and in the 1830s when the First Bank and the Second Bank of the United States were closed down?

2. What kind of services do banks offer today?

Electronic Banking (page 384)

When computers became widely used in the 1970s, the banking industry started using computers to perform functions previously handled on paper. This system is called electronic funds transfer (EFT). Automated teller machines (ATMs) were one of the advancements resulting from EFT systems. Banking customers can do their banking without the help of a bank teller by using ATMs. Many banks now offer services on the Internet. Using a computer to log on to the Internet, bank customers can check account balances, transfer funds, and even apply for loans.

The Electronic Funds Transfer Act of 1978 describes rights and responsibilities of participants in EFT systems. Among other things, this act guarantees that bank customers are protected against computer mistakes. For instance, if the balance on your bank statement is not what you believe it should be, your bank must investigate and correct the problem within a certain period of time.

3. What is one of the protections guaranteed by the Electronic Funds Transfer Act of 1978?
**TYPES OF MONEY IN THE UNITED STATES**

**KEY TERMS**

- **checking account**: Account in which deposited money can be withdrawn at any time by writing a check (page 389)
- **checkable deposits**: Money deposited in a bank that can be withdrawn at any time by presenting a check (page 389)
- **thrift institutions**: Mutual savings banks, S&Ls, and credit unions that offer many of the same services as commercial banks (page 389)
- **debit card**: Credit device used to make cashless purchases; money is electronically withdrawn from the consumer’s checkable account and transferred directly to the store’s bank account (page 389)
- **near moneys**: Assets, such as savings accounts, that can be turned into money relatively easily and without the risk of loss of value (page 390)
- **M1**: Narrowest definition of the money supply; consists of moneys that can be spent immediately and against which checks can be written (page 391)
- **M2**: Broader definition of the money supply; includes all of M1, plus such near moneys as money market mutual fund balances, certificates of deposit, and Eurodollars (page 391)

**DRAWING FROM EXPERIENCE**

Do you have a job for which you are paid by check? Do you deposit that check into a checking account? Or do you get cash for your paycheck and use the cash to pay for purchases? Why do most employers pay by check?

This section explains the different types of money used in the United States. It also explains how economists define the money supply in the United States.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read through the summaries that follow. Think about what are considered money and near moneys.

<table>
<thead>
<tr>
<th>Money</th>
<th>Near Moneys</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1.</td>
</tr>
<tr>
<td>2.</td>
<td>2.</td>
</tr>
</tbody>
</table>
READ TO LEARN

Money and Near Moneys (page 387)

These things are considered money: currency, or coins and bills, and deposits in checking accounts.

Coins make up 5 percent of currency in circulation today. Most of the currency in use is in the form of Federal Reserve notes. You know them as $1-bills, $5-bills, $10-dollar bills, etc. United States currency is printed by the Bureau of Engraving and Printing, which is part of the Treasury Department.

A checking account is money deposited in a bank. A person can withdraw this money by writing a check. The bank must pay the amount of the check when it is presented. Moneys deposited in checking accounts are called checkable deposits. Many banking institutions offer checkable deposit accounts, including thrift institutions. Thrift institutions include savings and loan associations (S&Ls), savings banks, and credit unions.

Many people think credit cards and debit cards are money. They are not. When you use a credit card, you are really taking out a loan from the credit card company. A debit card is used to make purchases, but it is not money either. The debit card gives an instruction to your bank that the seller may withdraw the amount of the purchase from your bank account.

Near moneys are assets that have a stated value and can be turned into money easily. The difference between money and near moneys is money can be accessed and spent immediately. Near moneys can be accessed easily, but not immediately. Near moneys are deposits in savings accounts and time deposits. These deposits cannot be withdrawn by a check. However, a person can go to the banking institution and withdraw these deposits. Then he or she can deposit the money in a checkable deposit account or just spend it in cash.

1. What is the difference between money and near money?

The Money Supply (page 391)

There are two definitions of money supply, or the amount of money currently in circulation. The first one, called M1, includes currency, deposits in checking accounts, and travelers’ checks. The second one, called M2, includes everything in M1 plus savings deposits, time deposits, small-denomination certificates of deposit, money market deposit accounts, money market mutual fund balances, and other more specialized account balances.

2. What are the two definitions of money supply?
ORGANIZATION AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM

KEY TERMS

Fed  Nickname for the Federal Reserve System (page 399)

monetary policy  Actions taken by the Fed to affect the amount of money in circulation (page 400)

Federal Open Market Committee  12-member committee that meets 8 times a year to set monetary policy (page 401)

check clearing  Method by which a check that has been deposited in one financial institution is transferred to the check writer’s financial institution (page 405)

DRAWING FROM EXPERIENCE

Have you ever received a check as a present from a far-away relative? What do you think happens after you cash the check at your local bank? After giving you the money, how does your bank get its money back? Does it mail the check to your relative’s bank and receive the cash by return mail? This section focuses on how the Federal Reserve System, the central banking organization of the United States, is organized to carry out check clearing and many other functions.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about who sets the policies of the Federal Reserve System.

<table>
<thead>
<tr>
<th>Group</th>
<th>Function</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of Governors</td>
<td></td>
</tr>
<tr>
<td>Federal Advisory Council</td>
<td></td>
</tr>
<tr>
<td>Federal Open Market Committee</td>
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READ TO LEARN

Organization of the Federal Reserve System (page 400)

Congress created the Federal Reserve System, or Fed as it came to be called, in 1913. Its major purpose was to bring an end to the recessions that had repeatedly occurred since the early 1800s. Over the years, the Fed has also taken on many other functions.

The Federal Reserve System is a network of banks. It consists of 12 district banks, 25 branch banks, and about 5,000 member banks. The Fed is responsible for monetary policy in the United States. Setting monetary policy involves changing the supply of money in circulation. This affects credit and, as a result, the amount of business activity in the economy.

A 7-member full-time Board of Governors, appointed by the President with Senate approval, directs the operations of the Fed. Members serve 14-year terms and cannot be reappointed—nor do their decisions require anyone’s approval. This arrangement frees Board members from political pressures in making their decisions. The Board is assisted by the Federal Advisory Council (FAC) and the Federal Open Market Committee (FOMC). The 12-member FOMC meets at least 8 times a year to decide on actions that the Fed should take to control the money supply. The FAC meets at least 4 times a year and reports the nation’s general business conditions to the Board. It consists of one representative from each of the system’s district banks.

Each part of the nation is served by one of the Federal Reserve System’s 12 district banks. Each district bank is a corporation that is owned by the member banks in its district. To become a member bank, an institution buys stock in its district bank. All national banks—those chartered by the federal government—are required to be member banks. State-chartered banks may become member banks if they wish to. However, all banks in a district are required to keep a portion of their deposits on reserve in an account at their Fed district bank.

1. What is the relationship between a district bank, member banks, and nonmember banks?

Functions of the Fed (page 405)

In addition to holding reserves, supervising member state banks, and regulating the money supply, the Federal Reserve supplies paper currency. Check clearing is another important—and complicated—function. This is the process of transferring funds between banks as checks are written on accounts in one bank and deposited into accounts in other banks.

The Fed also acts as the government’s bank. Tax money is deposited in accounts in district banks, and government agencies have checking accounts with the Fed. For example, Social Security benefits and tax refunds are paid by checks written on Federal Reserve accounts.

Finally, the Federal Reserve administers federal truth-in-lending laws. These are laws that require sellers to disclose information about interest rates and monthly payments to consumers.

2. Why does check clearing require that funds be transferred between banks?
MONEY SUPPLY AND THE ECONOMY

KEY TERMS

- **loose money policy**: Monetary policy that makes credit inexpensive and plentiful (page 408)
- **tight money policy**: Monetary policy that makes credit expensive and in short supply (page 408)
- **fractional reserve banking**: System in which only part of a bank’s deposits are kept on hand, the rest being available for loans to borrowers or otherwise invested (page 408)
- **reserve requirements**: Fed regulations that require banks to keep a certain percentage of their deposits as cash in their own vaults or as deposits in their Federal Reserve district bank (page 408)

DRAWING FROM EXPERIENCE

Perhaps you wanted to buy something but did not have the money. When you asked some relatives or friends for a loan, they replied “I’d like to help you, but money is pretty tight right now.” What effect did their tight money supply have on your ability to satisfy your want? Multiply that result by countless millions of consumers and you can begin to understand how the size of the nation’s money supply affects the health of the economy.

This section focuses on the effect of tight and loose money policies on the nation’s money supply, and on the Fed’s role in managing money policy.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Circle either high or low in each box. Think about the characteristics of loose and tight money policies and their effect on the money supply.

<table>
<thead>
<tr>
<th>Money Policy</th>
<th>Cost of Credit</th>
<th>Demand for Credit</th>
<th>Supply of Credit</th>
<th>Money Supply</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expansionary</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td></td>
<td>Low</td>
<td></td>
</tr>
<tr>
<td>Contractionary</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td></td>
<td>Low</td>
<td></td>
</tr>
</tbody>
</table>
READ TO LEARN

Loose and Tight Money Policies (page 407)

Like any good or service, credit has a cost. Credit is also subject to the laws of supply and demand. The cost of credit is the interest paid by the people or businesses that obtain it. The demand for credit drops as the cost of credit increases. The demand for credit increases as the cost of credit drops. When credit is inexpensive and plentiful, the nation is said to have a loose money policy. If credit is in short supply and is expensive to obtain, this is referred to as a tight money policy.

A loose money policy is often called “expansionary.” This is because it is intended to encourage economic growth. If credit expands too quickly, however, and money becomes too plentiful, inflation may result. In such a case, the Fed might adopt a tight money policy to slow the rate of economic growth. Because it has this effect, a tight money policy is called “contractionary.” The Fed’s responsibility and goal is to strike a balance. There should be enough money and credit in the economy to allow for growth, but not so much that rapid inflation results.

1. What is the relationship between credit and the money supply under a loose money policy?

Fractional Reserve Banking (page 408)

Part of the way that the Fed regulates the money supply is related to a practice called fractional reserve banking. Banks cannot make use of all the money deposited in them to make loans. Instead, the Fed puts a reserve requirement on banks. A bank must keep a certain percentage of its customers’ deposits as cash in its vaults or in its account at its Federal Reserve district bank. The purpose of these reserves is so that the bank will have money available if customers want to make large withdrawals from their accounts.

2. What is fractional reserve banking?

Money Expansion (page 409)

Deposits that banks are not required to keep in reserve are used to expand the money supply. Banks do this by making loans. When a bank makes a loan to a customer, it may deposit the loan amount in the customer’s checking account. The bank then treats that deposit, subject to its reserve requirement, as funds from which to make another loan. If the second loan is deposited in the second loan customer’s account, those funds become the basis for yet a third loan, and so on. When the bank’s customers spend the money they have borrowed, it eventually becomes deposits in businesses’ accounts in other banks. Those banks make still more loans from these funds, following the same practices as the original lending bank. This process is called the multiple expansion of the money supply.

3. If a bank has a 10 percent reserve requirement, how much money can it put into the economy by making three rounds of loans from a $1,000 deposit?
REGULATING THE MONEY SUPPLY

KEY TERMS

discount rate  Interest rate that the Fed charges on loans to member banks (page 414)
prime rate  Interest rate that banks charge on loans to their best business customers (page 414)
federal funds rate  Interest rate that banks charge each other on loans (usually overnight) (page 415)
open-market operations  The buying and selling of United States securities by the Fed in order to affect the money supply (page 416)

DRAWING FROM EXPERIENCE

Suppose that you have decided to buy a car on credit. A month ago you inquired about financing and the bank informed you of its interest rate on a three-year auto loan. Today you found the car you want to buy. However, you discover that the bank’s interest rate is now nearly one percent higher! You remember a news report a few days ago that the Fed has raised interest rates, but you did not think the government sets the interest rate on auto loans. What is going on here? Why has the cost of buying your car suddenly gone up?

This section focuses on the tools the Federal Reserve uses to control the money supply and keep the economy running smoothly.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about how the Federal Reserve affects interest rates and the money supply.

<table>
<thead>
<tr>
<th>How Fed Actions Affect Interest Rates and the Money Supply</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cause</strong></td>
</tr>
<tr>
<td>a. The Fed lowers the reserve requirement.</td>
</tr>
<tr>
<td>b. The discount rate goes up.</td>
</tr>
<tr>
<td>c. The federal funds rate goes _______________.</td>
</tr>
</tbody>
</table>
READ TO LEARN

**Changing Reserve Requirements** (page 412)

One way the Fed can control the money supply is by changing the reserve requirement. The lower the percentage of deposits that banks must keep in reserve, the more dollars they will have available to loan. The opposite is also true. Even small changes in the reserve requirement can have major effects on the money supply. Some believe this tool is not accurate enough to make frequent small adjustments in the money supply, so it has not been used in recent years.

1. What would happen to the money supply if the Fed raised the reserve requirement? Explain why.

**Changing the Discount Rate** (page 414)

If a bank’s reserves unexpectedly fall below the reserve requirement, the bank must borrow funds to increase its reserves. One way to do this is to ask its Federal Reserve district bank for a loan. Like other banks, the district bank charges interest. The interest rate the Fed charges member banks for loans is called the discount rate. If the discount rate is high, the bank passes its increased costs on to customers by charging higher interest rates on loans. For example, it might raise its prime rate—the interest rate it charges its best business customers. High interest rates slow the growth of the money supply by discouraging borrowing. On the other hand, if the discount rate is low, even a bank that does not need to borrow from the Fed may do so. The loan will raise the bank’s reserves, allowing it to make more loans. Therefore, lowering the discount rate increases the money supply.

The Fed rarely changes the discount rate, however. When the media reports that the Fed is considering a change in the “interest rate,” it is referring to the federal funds rate. This is the interest rate that banks charge each other for short-term loans. A bank may need such a loan if a depositor unexpectedly withdraws a large amount. If the bank’s reserves fall below the requirement, it must either borrow to restore them or pay a penalty to the Fed. If the discount rate is too high, the bank will approach another bank for the loan. When the Fed lowers the federal funds rate, banks borrow more and, thus, lend more. This increases the money supply in the economy. However, if the Fed raises the federal funds rate, banks will borrow less and raise the interest rates they charge their own customers.

2. What effect will raising the federal funds rate have on the money supply? Explain why.

**Open-Market Operations** (page 416)

Buying and selling government securities—called open-market operations—is the Fed’s major tool for controlling the money supply. When the Fed buys securities—such as Treasury bills—it pays for them by depositing money in the reserve account of the security dealer’s bank. When its
reserves increase, the bank can lend more money. On the other hand, when the Fed sells securities to dealers, it takes money from the reserve accounts of the dealers’ banks to pay for them. This action means that the banks have less money to support loans and must reduce their lending.

3. How does the Fed increase the money supply by buying government securities?

Difficulties of Monetary Policy (page 416)

The increasing complexity of the U.S. economy has made the Fed’s job of controlling the money supply more difficult. New savings and investment alternatives, the increased use of credit cards, and increased electronic transfers of funds have changed the way money circulates in the economy. The taxing and spending policies of the federal government also work to make the Fed’s job more difficult.

4. Why would the government’s tax policies affect the money supply?
GROWTH IN THE SIZE OF GOVERNMENT

KEY TERMS

*public-works projects* Facilities used by the public, such as schools and highways, built by federal, state, or local governments with public money (page 425)

*Medicare* A government program providing health care for the aged (page 426)

DRAWING FROM EXPERIENCE

Think about your trip to school. Are there any rules that you need to follow while driving, walking, or riding to school? Who makes these rules? How are they enforced? Who maintains the roads you ride on or the sidewalks that you walk on?

In this section, you will learn that government at every level is involved in almost every aspect of the U.S. economy.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about how the size of government is measured.

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How To Measure Government Size

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Government, along with supply and demand, is one of the most important elements affecting the distribution of resources throughout the economy. Government is involved in almost every aspect of the economy. Demand for government services grew during the Great Depression. Different levels of government grew at different rates. In the late 1960s, the federal government grew faster than state or local governments. The federal government spent money on national defense, salaries for members of Congress and federal judges, and public-works projects. Public-works projects are publicly used facilities, such as schools and highways, that are built and paid for with tax dollars. In the 1970s, federal expenditures diminished while state and local government spending on items such as sewers, roads, and schools increased rapidly.

1. Did all levels of government grow at the same rate? Explain.

Economists theorize that government has grown because people demanded more government services as the nation became richer. Government size can be measured by examining the size of government expenditures and “private sector” spending required by law. Today, total government spending represents about 18 percent of GDP. When government taxes you to provide you with a service, such as health care for the aged, or Medicare, this cost is included in the level of government spending. It does not include interest payments on the national debt and transfer payments, such as welfare programs. If you add these items, total government spending easily exceeds one-third of GDP. Government growth can be evaluated in terms of opportunity costs because government activity displaces private economic decision making, which is at the core of wealth creation and a rising standard of living.

2. How can government size be measured?
public goods These are goods or services that government provides to its citizens. They can be used by many individuals at the same time without reducing the benefit each person receives (page 430)

income redistribution A government activity designed to help citizens in need by taking money from some people through taxation (page 431)

social insurance programs Government programs financed by taxes paid into programs by workers and employers. These programs provide benefits to retired and disabled workers, their families, and the unemployed (page 431)

Social Security A federal government program that provides monthly payments to people who are retired or unable to work (page 431)

workers’ compensation A government program that provides medical payments to workers injured on the job (page 431)

public-assistance programs Government programs that make payments to citizens based on need (page 431)

welfare Same as public-assistance programs (page 431)

Supplemental Security Income Federal programs including food stamps and payments to the aged, blind, and disabled (page 431)

Temporary Assistance for Needy Families State-run public-assistance program that provides assistance and work opportunities to needy families with young children (page 431)

Medicaid State and federal public-assistance program that helps pay health care costs for low-income and disabled persons (page 431)

externalities Negative or positive economic side effects or by-products that impact on an uninvolved third party (page 432)

Have you ever wondered who pays for your school? How is the money collected? Why do these people pay for schools? How does education serve the public good?

In this section, you will learn about the four methods that government uses to support the general well being of all citizens.
ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about why government distributes income.

Government Promotes the General Well-Being of All Citizens

READ TO LEARN

- Providing Public Goods (page 430)

Public goods are special goods or services that government provides for citizens. Many people can use public goods at the same time without reducing the benefit each person receives. Streetlights and national defense are two examples. Different levels of government can provide similar public goods, such as federal and local courts. A sound system of property rights is the most important public good that only government can provide. Property rights allow individuals to own factors of production, to risk investment, and to discover new ways of production. It allows individuals to freely enter into contracts, which government enforces. Merit goods are public goods that are socially desirable, such as museums. Government leaders may support such goods by requiring all taxpayers to subsidize them. Demerit goods are public goods that elected officials deem socially undesirable, such as gambling or injurious drugs. Government taxes, regulates, or prohibits the manufacture, sale, and use of such goods.

1. What are public goods?

- Redistributing Income (page 431)

Government provides for the public well-being by assisting specific groups, including the aged, the ill, and the poor, with minimum levels of income or health-care support. Income redistribution, or using tax receipts to assist citizens in need, is conducted in two general categories.
A. Social insurance programs pay benefits to retired and disabled workers, their families, and the unemployed. These programs are paid for by taxes. Social Security provides monthly payments to people who are retired or unable to work. Workers’ compensation is a state program that provides payments for medical care to workers injured on the job.

B. Public assistance programs are often called welfare. These programs are different from social insurance programs because payments are based on need, regardless of whether a person has paid taxes into the program. Supplemental Security Income, a federally financed and administered program providing payments to the aged, blind, and disabled, is one example of a public assistance program. Another example is the state-run Temporary Assistance for Needy Families, which provides assistance to needy families raising young children. Medicaid is a program financed by state and federal governments that helps pay health care costs for low-income and disabled persons.

2. What are the differences between social insurance programs and public assistance programs?

3. What are externalities?

4. How does government try to ensure economic stability?

5. What are the three main criticisms of government involvement in the economy?
THE FEDERAL BUDGET AND THE NATIONAL DEBT

KEY TERMS

- **fiscal year** A year by which accounts are kept. For the federal government, the fiscal year is October 1 to September 30 of the next year (page 437)
- **budget deficit** Occurs when government spending exceeds the amount of tax receipts for a fiscal year (page 438)
- **deficit financing** A government policy of spending more money than it is able to bring in through revenues (page 439)
- **national debt** The federal government’s total outstanding debt (page 439)
- **budget surplus** Occurs when government revenues are larger than its expenditures during the fiscal year (page 439)

DRAWING FROM EXPERIENCE

How do you or family members spend your income? What do you purchase? Who decides what to purchase? What happens when you need to buy something immediately but you do not have the cash to purchase it right now?

As you read this section, you will learn how the government prepares its budget and decides where to spend its funds.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the five steps in the federal budget-making process.

The Federal Budget-Making Process

READ TO LEARN

- **Introduction** (page 435)

Government at all levels spends huge sums to carry out all of its functions. Because resources (taxes) are scarce, increased spending in one area will result in decreased spending in another.
Considerable debate and compromise are necessary in preparing the annual budgets for every level of government. Prior to the beginning of the federal government’s fiscal year, the executive branch outlines a tentative budget for the next fiscal year. Various departments and agencies bargain with the Office of Management and Budget (OMB) for larger allocations of funds. The President approves the plan and submits it to Congress by January. Congressional committees, with the assistance of the Congressional Budget Office (CBO), review the proposed budget. Congress is required to pass two budget resolutions that set binding limits on spending and taxes for the next fiscal year. These resolutions often do not get passed on time and are not always treated as binding. Continuing resolutions, which Congress can pass, allow government spending to continue if a new fiscal year begins without a budget.

1. What are the major steps in the budget-making process?

Deficit Spending and the National Debt

Federal government revenues have not always been equal to government spending. A budget deficit occurs when government spends more money than it collects in taxes. Government overspending is called deficit financing. From 1940 through 1998, federal government spending averaged 23 percent of GDP, but revenues were only about 19 percent of GDP. The difference between spending and revenues is made up by borrowing. Government borrows money by selling federal securities, such as Treasury bonds, notes, and bills. Individual federal agencies as well as state and local governments may also sell bonds. The total amount of outstanding debt for the federal government is called the national debt or public debt. Citizen fears that the government was living beyond its means lessened when the government ran a budget surplus in 1998, 1999, and 2000. A budget surplus occurs when government revenues exceed spending during a fiscal year.

2. How do budget deficits and surpluses occur?
KEY TERMS

**benefits-received principle** A taxation system in which those who use a government service pay for it with taxes in proportion to the benefit they receive. People who do not use the service do not pay taxes for it (page 440)

**ability-to-pay principle** A taxation principle requiring people with higher incomes to pay more taxes than individuals with lower incomes regardless of the number of government services used (page 442)

**proportional tax** Taxes that take the same percentage of all incomes. As income rises, the amount of tax paid also rises (page 443)

**progressive tax** A tax that takes a larger percentage of higher incomes than lower incomes. It is justified on the ability-to-pay principle (page 443)

**regressive tax** A tax that takes a larger percentage of lower incomes than higher incomes (page 443)

**DRAWING FROM EXPERIENCE**

Have you ever looked carefully at your paycheck stub or a sales receipt? How could you tell that you paid taxes? Did everyone who received a paycheck or purchased something that same day pay the same amount of tax?

In the following section, you will read about the major kinds of taxes paid in the United States.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about the principles and purposes of taxation.

---

**Government Taxes**

**Principles of Taxation**

1. ____________________
2. ____________________

**Forms of Taxation**

1. ____________________
2. ____________________
3. ____________________
**READ TO LEARN**

**Principles of Taxation (page 440)**

Taxes are usually justified according to two major principles.

A. The **benefits-received principle** requires those who benefit from a federal government program to support it with taxes. These taxes are proportional to the benefit that an individual receives from the program.

B. The **ability-to-pay principle** requires those with higher incomes to pay more taxes than those with lower incomes. Tax payments are not based on the number of government services that an individual uses.

1. What is the difference between the benefits-received principle and the ability-to-pay principle?

**Forms of Taxation (page 442)**

Taxes are classified by the effect they have on those who are taxed. In the U.S., there are currently three categories of taxes.

A. **Proportional Tax** Taxes are in proportion to the income you have earned.

B. **Progressive Tax** Those who earn higher incomes pay higher taxes in proportion to the increases in their income. The ability-to-pay principle is used to justify this type of taxation.

C. **Regressive Tax** The percentage of income that you pay in taxes actually goes down as you make more money income.

2. Under a regressive tax system, who pays a higher percentage of their income in taxes, people with higher incomes or people with lower incomes?
UNEMPLOYMENT AND INFLATION

KEY TERMS

stabilization policies Federal government attempts to keep the economy healthy, including monetary and fiscal policies (page 451)
unemployment rate Percentage of civilian labor force that is unemployed but is actively looking for work (page 452)
full employment An economic condition that occurs when the unemployment rate is lower than a certain number established by economists’ studies (page 453)
underground economy Transactions conducted by people who do not follow federal and state laws with respect to reporting earnings (page 453)
demand-pull inflation A theory that prices rise due to excessive business and consumer demand; demand increases faster than total supply, resulting in shortages that lead to higher prices (page 454)
stagflation Combination of inflation and low economic activity (page 455)
cost-push inflation A theory that prices are pushed up by wage demands of labor unions and the excessive profit motive of large corporations. The result is stagflation (page 455)

DRAWING FROM EXPERIENCE

Your income and the prices of goods and services determine how much you will buy. Suppose you no longer receive an income from your job or your allowance. Will you continue buying things? Or, if prices rise, you may buy less. The entire economy may slow down from these conditions—unemployment or inflation.

In this section, you will learn that high unemployment and inflation are the two biggest threats to the nation’s economic stability.

ORGANIZING YOUR THOUGHTS

Use the table below to help you take notes as you read the summaries that follow. Be sure to note the differences between demand-pull inflation and cost-push inflation.

<table>
<thead>
<tr>
<th>Threats to Economic Stability</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Types of Unemployment</td>
<td>1. Cyclical:</td>
</tr>
<tr>
<td></td>
<td>2.</td>
</tr>
<tr>
<td></td>
<td>3.</td>
</tr>
<tr>
<td></td>
<td>4.</td>
</tr>
<tr>
<td>Types of Inflation</td>
<td>1. Demand-Pull:</td>
</tr>
<tr>
<td></td>
<td>2.</td>
</tr>
</tbody>
</table>
Unemployment and inflation cause uncertainty in the economy. The federal government uses monetary and fiscal policies to make the future more stable. Unfortunately these policies are not always successful.

1. What are the two policies that combine to make up a stabilization policy?

Economists often disagree about the causes and cures of economic problems. The unemployment rate measures the percentage of the civilian labor force that is without jobs and still actively looking for work. There are four types of unemployment: cyclical, structural, seasonal, and frictional. **Cyclical:** depends on business cycles. **Structural:** caused by changes in the economy such as technology or prices of resources. **Seasonal:** caused by changes in the seasons. **Frictional:** is temporary, reflecting time between jobs. Economists generally believe that full employment exists when the unemployment rate is below 5 percent. This rate is difficult to measure accurately. It does not count people who have stopped looking for work, those who work in family businesses without receiving pay, and people who participate in the **underground economy.** The underground economy includes tax avoiders, gamblers, and drug traffickers—people who do not report their earnings as required by the law.

2. Why is it difficult to measure unemployment?

**Inflation** means that excessive demand drives up prices. Such events as a rapid growth in the money supply, increases in government spending, decreased taxes, or a reduction in consumer savings can result in excessive demand. Consumers and/or government bid up prices as they compete with each other for goods in short supply.

The theory of **cost-push inflation** states that the wage demands of labor unions and the excessive profits of corporations push up prices. If businesses raise prices of goods and services, workers will demand an increase in wages to maintain their standard of living. Unemployment can remain high because prices are being adjusted for higher wages without a rise in aggregate demand. These circumstances are also known as **stagflation.**

3. What is the difference between demand-pull and cost-push inflation?
The Fiscal Approach to Stabilization

**KEY TERMS**

- **fiscal policy** The federal government’s use of taxation and spending policies to affect overall business activity (page 457)
- **circular flow of income** An economic model showing the continuous flow of income between businesses and consumers (page 458)

**DRAWING FROM EXPERIENCE**

Where do employers get the money to pay your wages? If you answered “From the goods or services they sell,” you are right. You also are beginning to understand the circular flow of income. When you spend money, you help keep other people employed. Understanding these exchanges over the entire economy is central to understanding the fiscal approach to economic stabilization.

In this section, you will learn that some economists believe fiscal policies can stabilize the economy.

**ORGANIZING YOUR THOUGHTS**

Use the circular flow model below to take notes on the summaries that follow. Be sure to understand the fiscal approach to promote economic stability.

**READ TO LEARN**

- **Introduction** (page 457)

Most economists support one of two theories of economic stabilization. One group emphasizes the role of monetary policy and the Federal Reserve in stabilizing the economy. The other group concentrates more on the use of fiscal policy, which is the federal government’s deliberate use of its taxation rates and expenditures to affect overall business activity.
1. What is fiscal policy?

John Maynard Keynes (page 457)
John Maynard Keynes believed that the forces of aggregate supply and aggregate demand operated too slowly in a serious recession. During the Great Depression Keynes urged government to stimulate aggregate demand.

2. Was Keynes a supporter of monetary or fiscal policy?

The Circular Flow of Income (page 458)
Income flows in a circle. It flows from businesses to households as wages, rent, interest, and profits. Income flows from households to businesses as payments for consumer goods and services. Money enters and leaves the cycle through injections and leakages. Injections from business investment or government spending place more money into the circular flow of income. Leakages, such as consumer saving and government taxation, remove money from the circular flow of income.

3. What impact do leakages and injections have on the circular flow of income?

Fiscal Policy and Unemployment (page 459)
Some public officials and labor leaders favor jobs programs to stimulate the economy. Another way to stimulate the economy is cutting federal taxes. For example, government may encourage businesses to expand production and hire workers by tax cuts.

4. How do federal jobs programs inject money into the economy?

Fiscal Policy and Supply-Side Effects (page 459)
Fiscal policy advocates believe that tax cuts lead to more business investment, more jobs, and more saving. Because the supplies of investments, jobs, and savings are key ingredients in economic growth, they are called supply-side effects of fiscal policy.

5. How can fiscal policy be used to increase growth?
MONETARISM AND THE ECONOMY

KEY TERMS

monetarism A theory that deals with the relationship between the amount of money the Fed places in circulation and the level of activity in the economy (page 462)
monetarists Supporters of the theory of monetarism linked with economist Milton Friedman (page 462)
monetary rule Fed rule that would allow the money supply to grow consistently at a rate of 3 to 5 percent per year (page 463)
time lags These are periods between the time fiscal policy is enacted and the time it becomes effective (page 465)

DRAWING FROM EXPERIENCE

Have you or a member of your family ever looked at interest rates before you made a major purchase? Did a higher or lower interest rate affect your decision to make a large purchase, such as a house or a car? Did the interest rate on a credit card ever affect your decision or a family member’s decision to make a purchase with that card? Monetarists believe that understanding such decisions is important to creating economic stability.

In the last section, you learned about the fiscal approach to economic stability. This section will introduce you to a competing stabilization theory called monetarism, which deals with the relationship between the amount of money the Federal Reserve places in circulation and the level of activity in the economy.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Make sure that you understand the monetarist explanation of the Great Depression and their plans to promote economic stability.

<table>
<thead>
<tr>
<th>Ideas</th>
<th>Explanations</th>
</tr>
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<tbody>
<tr>
<td>&quot;the monetary rule&quot;</td>
<td></td>
</tr>
<tr>
<td>Criticism of Fiscal Policy</td>
<td>1.</td>
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<td></td>
<td>2.</td>
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</tbody>
</table>
Monetarism is a theory that deals with the amount of money the Fed places in circulation. Milton Friedman and other economists believe that the Federal Reserve should increase the money supply at a regular rate each year. If the amount of money in circulation expands too fast people spend more. Excess demand may cause businesses to hire more workers. However, if full employment exists, rising aggregate demand will lead to inflation.

1. What do the monetarists think the government and the Fed should do to stabilize the economy?

Monetarists oppose using fiscal policy to stimulate or to slow the economy. The economy is too complex and too little understood for government action to have a positive effect. Instead, government should balance the federal budget. This will keep government from competing with private business to borrow money and also reduce the amount of interest that government must pay each year. The Fed should follow the monetary rule, or allow the money supply to grow smoothly and consistently at 3 to 5 percent each year. This is the best way to control economic expansion without rapid inflation or high unemployment.

2. What specific steps do monetarists think government should take to stabilize the economy?

Monetarists believe fiscal policy fails to match economic reality for two reasons. First, no single government body designs and implements fiscal policy. Congress and the president often disagree over fiscal policy. Politicians have more incentives to take actions for today rather than the long run. Second, there are various time lags between the time a policy is enacted and the time it becomes effective. A fiscal policy designed to combat a recession might not produce results until the economy is already experiencing inflation.

3. Why do monetarists believe that theories of fiscal policy do not match economic realities?
**KEY TERMS**

- **Imports**  Goods bought from other countries for domestic use (page 473)
- **Exports**  Goods sold to other countries (page 474)
- **Absolute Advantage**  Ability of one country, using the same quantity of resources as another country, to produce a particular product more efficiently (page 475)
- **Specialization**  Concept that a nation should produce and export a limited assortment of goods for which it is particularly suited in order to remain profitable (page 475)
- **Comparative Advantage**  Ability of a country to produce a product at a lower opportunity cost than another country (page 476)

**DRAWING FROM EXPERIENCE**

What is the name brand on the computer you use at school? Do you think that all the parts in that computer were made in the United States? Is it possible that a computer made by an American company like IBM contains parts made in other nations?

This section explains international trade and the value of exports and imports. It also explains the factors that determine what goods a nation produces.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the television in your household and where it might have been manufactured.

<table>
<thead>
<tr>
<th>Absolute Advantage</th>
<th>Comparative Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition:</td>
<td>Definition:</td>
</tr>
<tr>
<td>Example:</td>
<td>Example:</td>
</tr>
</tbody>
</table>

**READ TO LEARN**

- **Benefits of Trade**  (page 474)

Imports make up about 14 percent of the United States’ GDP, or Gross Domestic Product. Fourteen percent might not seem like much. However, life in the United States would be very different without **imports**, or goods bought from other countries. Specifically, there would be no coffee, pepper, or chocolate in the United States because these items are imported from other countries.
Exports are goods sold to other countries. More than 40 percent of the engineering and scientific instruments manufactured in the United States are sold to consumers in other countries. Nearly half of all the wheat produced in the United States is sold to consumers in other countries.

Some products that appear to be made in the United States might contain parts made in other countries. For instance, Minute Maid and Tropicana orange juices are made from concentrate that comes from the United States, Mexico, or Brazil. So, even though Minute Maid packages orange juice in the United States, they might use resources that are imports from other countries.

Nations differ in the factors of production they have available for use. The factors of production in any nation are natural resources, labor, capital, and entrepreneurship. The United States has a highly skilled labor force and large amounts of capital. This is why the United States is well suited for producing scientific instruments. Another country that does not have the same highly skilled labor force and large amounts of capital, will not be well suited for producing scientific instruments.

1. What factors of production must a nation have to be well suited for producing scientific instruments?

Absolute vs. Comparative (page 475)

The relative cost of production helps determine what a nation will import and export. Also, all nations must make choices about how they use their scarce resources, or resources that are limited in supply such as natural resources, time, and money.

Brazil's tropical climate is ideal for growing bananas. Suppose France uses the same amount of labor, land, and capital as does Brazil to grow bananas. France will never produce as many bananas as does Brazil because France does not have a tropical climate. This means that Brazil has an absolute advantage over France in the production of bananas. Absolute advantage is when one nation can produce a particular product more efficiently than another nation, even though both countries use the same amount of resources.

Some nations are well suited for producing and making a profit on certain goods. This is called specialization. For instance, Japan's specialization is consumer electronics, such as CD players and televisions. Many countries import consumer electronics from Japan.

One nation can have a comparative advantage over another nation in producing a particular good. Comparative advantage is the ability of one nation to produce a product at a lower opportunity cost than another country. In this instance, a lower opportunity cost means that the trade-offs involved in producing a particular good are well worth the profit made from selling the good. For example, the United States has a comparative advantage over many countries in the production of scientific instruments. Other nations might produce scientific instruments, but the United States can produce these goods at a lower opportunity cost than most other nations.

The purpose of international trade is to obtain imports. We export goods in order to obtain funds. With these funds we import goods that we can not produce efficiently ourselves. In other words, in international trade exports pay for imports.

2. What is the difference between absolute and comparative advantage?
**Exchange Rate**

The price of one nation’s currency in terms of another nation’s currency (page 479)

**Foreign Exchange Markets**

Markets dealing in buying and selling foreign currency for businesses that want to import goods from other countries (page 480)

**Fixed Rate of Exchange**

System under which a national government sets the value of its currency in relation to a single standard (page 480)

**International Monetary Fund (IMF)**

Agency whose member governments once were obligated to keep their foreign exchange rates more or less fixed; today it offers monetary advice and provides loans to developing nations (page 481)

**Devaluation**

Lowering a currency’s value in relation to other currencies by government order (page 481)

**Flexible Exchange Rates**

Arrangement in which the forces of supply and demand are allowed to set the price of various currencies (page 482)

**Depreciation**

Fall in the price of a currency through the action of supply and demand (page 482)

**Balance of Trade**

Difference between the value of a nation’s exports and its imports (page 483)

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**Drawing From Experience**

Have you ever thought about how businesses purchase goods from foreign countries? How does a business in the United States use U.S. dollars to purchase goods from Japan where the medium of exchange is the yen?

This section focuses on exchange rates, or how the price of one nation’s currency is expressed in terms of the price of another nation’s currency. It also explains how exchange rates affect international trade.

**Organizing Your Thoughts**

Use the diagram below to help you take notes as you read through the summaries that follow. Think about how exchange rate systems have changed to benefit businesses and global trade.
In the United States, the dollar is our medium of exchange. Remember that a medium of exchange is something a seller will accept in exchange for a good or service. In order for nations to be involved in international trade, there must be an established exchange rate, a price for one nation’s currency in terms of another nation’s currency. Also, there must exist a way in which individuals, nations, or businesses exchange one type of currency for another. In order to do this, businesses must be able to convert one currency to another easily. Foreign exchange markets deal in buying and selling foreign currency for businesses that want to import goods from other countries. Foreign exchange markets daily list the price of one nation’s currency in comparison to another nation’s currency.

1. What do foreign exchange markets do?

From 1945 to the early 1970s, a fixed rate of exchange was used to trade currency. A fixed rate of exchange means that a national government sets the value of its currency in relation to a single standard such as gold. For example, the value of the United States dollar had to be determined by the amount of gold the United States held in reserve. Before 1970, member governments of the International Monetary Fund (IMF) had to keep their foreign exchange rates more or less fixed. IMF member governments had to set the value of their currency by a single standard that each government held in reserve.

One of the benefits of a fixed rate of exchange was that it allowed importers and exporters to know exactly how much currency they could purchase with their nation’s money. A fixed exchange rate also allowed central banks to affect the level of imports and exports in their country by devaluing their country’s currency. A devaluation occurs when the value of one country’s currency is lowered in relation to other nations’ currencies by government order. If Japan devalues its yen by one-half, then the cost of Japanese goods to consumers in the United States will decrease.

The system of fixed exchange rates became impractical. In a global economy, the economic climate changes constantly. Suppose the United States experiences high inflation and Japan does not. As a result, United States products become too expensive for Japanese consumers to buy. At the same time, Japanese products become very affordable for Americans to buy. The result is that United States imports large quantities of goods from Japan, but exports very little to Japan. Since exports pay for imports, the United States is not exporting enough goods to pay for the amount of goods it imports from Japan.

2. Why were fixed exchange rates impractical?
Flexible Exchange Rates (page 482)

In 1971, President Richard Nixon announced the end of fixed American exchange rates. After that announcement, many nations followed the United States by switching to a flexible exchange rate. Under a system of flexible exchange rates, supply and demand determine the value of one nation's currency against another. With flexible exchange rates, a nation's currency can change, or go up and down, a little each day. Suppose the amount of American dollars wanted by Japanese exporters is more than the quantity of dollars supplied by Americans buying Japanese goods. Then the American dollar will become more expensive in relation to the Japanese yen. In other words, it will take more yen to equal one dollar. This follows the basic law of supply and demand. When the demand is high and the supply is low, then the price goes up.

Suppose the opposite is true, that the quantity of dollars American importers supply is more than the quantity demanded by Japanese exporters. Then the American dollar will become cheaper in relation to the Japanese yen. Fewer yen will equal one dollar. In this case, when the American dollar becomes cheaper in relation to the Japanese yen, we call it depreciation. Depreciation of a country's currency occurs when the price of that currency falls as a result of supply and demand.

3. What is a flexible exchange rate?

Balance of Trade (page 483)

Balance of trade is the difference between the value of a nation's exports and its imports. When a nation's currency depreciates, or becomes "weak," that nation will probably export more goods. This happens because those goods become cheaper for other nations to buy. If on a given day the American dollar depreciates against the Japanese yen, then the Japanese can purchase more American-made goods for their money. At the same time, America will import fewer goods from Japan because its depreciated dollar will have less purchasing power in Japan. This example is called a positive balance of trade, when the value of exports exceeds the value of imports.

If the opposite is true, it is called a negative balance of trade, or a trade deficit. This occurs when the value of a nation's imports is greater than the value of its exports. A trade deficit usually brings with it a negative balance of payments, which occurs when a nation spends more money abroad than it receives from other countries. A trade deficit is not necessarily a bad thing. For instance, if the value of United States exports is high, that means foreigners are investing in the U.S. economy. When foreigners invest money in the U.S. economy, it benefits the U.S. by creating jobs and supporting industries in the U.S.

4. What is the benefit of a trade deficit?
RESTRICTIONS ON WORLD TRADE

KEY TERMS

tariff Tax placed on an imported product (page 486)
revenue tariff Tax on imports used primarily to raise income without restricting imports (page 487)
protective tariff Tax on imports used to raise the cost of imported goods and thereby protect domestic producers (page 487)
import quota Restriction imposed on the value of or on the number of units of a particular good that can be brought into the country (page 487)
embargo Complete restriction on the import or export of a particular good (page 487)
protectionists People who argue for trade restrictions to protect domestic industries (page 487)
General Agreement on Tariffs and Trade Trade agreement under which countries met periodically to negotiate tariff reductions that were mutually advantageous to all members (page 488)
World Trade Organization World’s largest trade agreement among more than 140 nations (page 488)
North American Free Trade Agreement Trade agreement designed to reduce tariff barriers among Mexico, Canada, and the United States (page 489)
European Union Organization of European nations whose goal is to encourage economic integration as a single market by eliminating restrictions on trade and using a common currency. (page 489)

DRAWING FROM EXPERIENCE

Do you remember learning about the Boston Tea Party in American history class? Do you remember why the colonists thought the tax on tea imposed by England was unfair?

This section explains restrictions that governments impose on imports. It explains why these restrictions are sometimes necessary. Also, it outlines several international trade agreements signed during the 1900s.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the pros and cons of free trade and import restrictions.

<table>
<thead>
<tr>
<th>Ways to Restrict Imports</th>
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<td>1.</td>
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<thead>
<tr>
<th>Trade Agreements</th>
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<tr>
<td>1.</td>
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<tr>
<td>2.</td>
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<tr>
<td>3.</td>
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<tr>
<td>4.</td>
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</tbody>
</table>
Three Ways to Restrict Imports (page 486)

There are three major ways to restrict imports. The first is tariffs, or taxes on imports. Some governments apply revenue tariffs to imports. Revenue tariffs raise a government’s income without restricting the amount or type of imports. Until the early 1900s, the United States government obtained most of its revenue, or income, from revenue tariffs. Some governments apply protective tariffs to imports. A protective tariff raises the cost of imported goods in order to protect domestic producers. For instance, a government might apply a protective tariff to imported cars if that country is trying to establish its own car manufacturing industry. Making imported cars more expensive will help encourage the population to purchase domestic-made cars. Tariffs are not used as much today as they have been in the past.

The second major way to restrict imports is to enact a quota system. An import quota usually restricts the amount of a product being imported into a country. The United States has placed quotas on imports of sugar, shoes, shirts, and cloth.

The third major way to restrict imports is by imposing embargoes. An embargo is a complete restriction on imports or exports. Most embargoes are enacted for political reasons. For example, in 1980 President Jimmy Carter ordered an embargo on all grain exports to the Soviet Union. He did this because the Soviet Union had invaded Afghanistan. Some embargoes are enacted on a particular good. For example, in the 1990s there were embargoes on the importation of yellowfin tuna from certain countries that did not meet “safe dolphin” fishing requirements.

1. What is the difference between a revenue tariff and a protective tariff?

Arguments Against Free Trade (page 487)

Whether or not free trade is good or bad is a matter of intense public debate. People who argue against free trade and for trade restrictions such as tariffs and quotas are called protectionists. Protectionists use three main arguments to support their opinion. Protectionists argue that in order to ensure job security for domestic workers, a nation must restrict imports. This way, American manufacturers will not have to compete with lower-priced goods from other countries. For example, in the 1980s, imported steel became much less expensive than steel manufactured in American steel mills. Because there were no restrictions or tariffs on imported steel, most businesses purchased imported steel. As a result, American steel mills lost business and had to lay off many workers. Protectionists also argue that the nation’s economic security is dependent upon certain industries. Protectionists further argue that a new, or infant, industry needs to be protected from foreign competition until that industry can compete in the world market.
2. What are three main arguments used by protectionists?

- Arguments For Free Trade (page 488)

There are three main arguments in support of free trade. People who believe in free trade argue that foreign competition encourages United States firms to improve their products. The second argument in support of free trade is that many American workers produce goods that are exported. If other countries restrict their imports, then that hurts the American exporters. If the United States restricts imports, other nations might retaliate and restrict their imports. The third argument in support of free trade is that specialization benefits consumers. When countries specialize in producing certain goods, those goods are usually available to other countries at a lower price.

3. What are the three main arguments in support of free trade?

- Trade Agreements (page 488)

Trade agreements enacted in the last half of the 20th century reflect a global trend toward fewer trade restrictions. The General Agreement on Tariffs and Trade (GATT) is an agreement that was signed after World War II. Under GATT, countries agreed to negotiate tariff reductions that would benefit all member nations.

The World Trade Organization (WTO) was formed in 1994 when the nations belonging to GATT signed a new treaty. The goal of the WTO is a 40 percent reduction in tariffs by 2005. This is the most far-reaching global trade agreement in history.

Smaller regional trade agreements also have been signed. For instance, the United States reached an agreement with Canada and Mexico called the North American Free Trade Agreement (NAFTA). Since this treaty was approved, trade has increased among the three nations. The most important regional trade agreement today is the European Union (EU). As of 2000, 15 European countries made up the EU. Starting in 2004, 10 more countries planned to join. One of the goals of the EU is to enact a common currency among its member nations. The EU also has helped eliminate trade restrictions among its member nations.

4. What is the global trend in trade agreements today?
Comparing Capitalism and Socialism

**KEY TERMS**

- **proletariat**: Term used by Karl Marx and by other communists to mean workers *(page 499)*
- **communism**: An economic system in which, in theory, the means of production are owned collectively by all the people and in which there is no need for a government *(page 500)*
- **democratic socialism**: An arrangement in which a socialist economic system exists alongside a democratic government, which controls some areas of the economy *(page 500)*
- **authoritarian socialism**: A socialist system in which the entire economy is controlled by a central government *(page 500)*

**DRAWING FROM EXPERIENCE**

What do you want to do after you graduate? Do you intend to go to college or to a vocational school? Perhaps you hope to quit your current part-time job and get a better-paying full-time job doing something that truly interests you. Your ability to make such decisions—and the fact that you have choices—largely results from the benefits of a capitalist economic system. If you lived in an authoritarian socialist nation, the government would make many of these decisions for you.

This section focuses on the differences between capitalist and socialist systems.

**ORGANIZING YOUR THOUGHTS**

Use the chart below to help you take notes as you read the summaries that follow. Think about the differences between socialism and market capitalism.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Capitalism</td>
<td>a.</td>
<td>b.</td>
<td>c.</td>
</tr>
<tr>
<td>Socialism</td>
<td>d.</td>
<td>e.</td>
<td>f.</td>
</tr>
</tbody>
</table>

**READ TO LEARN**

- **Pure Market Capitalism** *(page 498)*

Pure capitalism operates on the basis of the three Ps: Prices, Profits, and Private Property. Prices seek their own level as determined by the law of supply and demand. Private property rights exist and are enforced by law. People must take risks if they wish to earn profits, and individuals, not government, decide all three basic economic questions. Government’s role is limited to providing public goods, such as defense and police protection.
1. What are the three Ps of pure market capitalism?

Pure Socialism (page 498)

Pure socialism is an economic system in which the state owns most factors of production. There is very little private property. Prices are set by the state rather than by supply and demand, and government officials decide the three basic economic questions. The state takes all the risk and all citizens pay for unsuccessful risk taking. Individual risk taking is not allowed.

Socialism grew out of the problems that resulted from the Industrial Revolution of the 1800s. Karl Marx saw a struggle going on between the owners of the factors of production—the “capitalists”—and the workers, whom Marx called the proletariat. Marx believed that it was wrong for the capitalists to keep profits they made from goods the proletariat produced. He argued that these profits rightfully belonged to the workers who produced the goods. Marx called on the proletariat to overthrow the capitalist system and replace it with one in which the workers owned and controlled the means of production. At first, he predicted, the government would exercise this control. Marx believed that eventually, however, this socialist system would change into communism—a socialist-type system that had no need for a government.

Marx’s predictions did not come true. Instead, in the twentieth century socialism split into two major forms. In democratic socialism, an elected government makes the economic decisions, and usually for only certain areas of the economy. Under authoritarian socialism, capitalism is overthrown and a central government forces socialism on the entire economy. People today apply the term “communism” to authoritarian socialist systems.

2. What is the difference between democratic and authoritarian socialism?

The Benefits of Capitalism (page 500)

Economists like to compare the advantages and disadvantages of capitalism and socialism. Critics of socialism note that capitalism stresses personal freedom while socialism requires centralized planning. They point out that to plan the economy, government must affect people’s personal lives. All economies are planned, but in capitalist systems individual and private businesses do most of the planning. In socialist systems, central planners make decisions for everyone.

3. How would living in a government-planned economy affect people’s daily lives?
CHANGING AUTHORITARIAN SOCIALISM—
THE CASE OF CHINA

KEY TERMS

- **five-year plans**  Centralized planning system that once was the basis for China’s economic system (page 504)
- **World Trade Organization (WTO)**  An international organization that regulates trade among most of the world’s nations (page 506)

**DRAWING FROM EXPERIENCE**

Do you know that plagiarism—claiming a writer’s words and ideas as your own—is not only dishonest, it is illegal? In a capitalist system, authors own what they write—or it belongs to the company that publishes their work. If you use that work without acknowledging its ownership in a paper, you are stealing someone’s property. These same rights do not exist in communist nations such as China.

This section focuses on communism as it is practiced in China and on the movement toward property rights in that nation.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about the steps that China has taken to move toward a mixed economy.

*China’s Transition to a Mixed Economy*

- 1958:
- 1978:
- 1980s:
- 1999:
READ TO LEARN

Development of China’s Economic System (page 503)

Communists took control of China after World War II. In 1953 they introduced a centralized economic planning system based on what they called *five-year plans*. National planning quickly failed, and in 1957 the Communists moved toward a regional planning system. However, economic conditions worsened. In 1978 the government tried to motivate people to work harder by allowing individuals to rent land. They were required to produce a certain amount for the state. Anything they produced over that amount became their property. The reform worked well. By 1984, farm productivity had increased dramatically.

In the mid-1980s Communist leaders launched more reforms. Managers of state-owned businesses today have much more decision-making power than they did before. After they have met the government’s production requirements, they can start producing to meet market demand. They also can sell part of their output at market prices to whomever they choose.

1. Why would the reforms of the 1970s and 1980s cause an increase in productivity?

The Transition Toward a Mixed Economy (page 505)

One of the most important aspects of pure capitalism is well-defined property rights. In China, however, property rights remain a problem. The state owns many urban industries. In the countryside, it still rents much of the land to farmers. Because they don’t have ownership, farmers are not interested in investing in farm equipment or in improving their land.

Lawlessness and unpredictability are common problems in doing business in China. This is especially true for foreign companies. The state still controls many resources, and government officials continue to seek bribes. Communism shows little respect for property rights. For example, Chinese factories routinely “pirate” compact discs of American musicians.

2. Why would the lack of property rights discourage farm productivity?

Prospects for China’s Economic Future (page 506)

Many foreign companies are present in China, attracted by its huge market of 1.3 billion people. In 2000 China became a member of the *World Trade Organization (WTO)*, an organization that regulates trade among many of the world’s nations. China’s inefficient state-owned industries are being forced to face many economic reforms. WTO membership has increased the prospects for a more prosperous, democratic, and stable China.

3. Why would foreign trade force China’s state-owned industries to reform?
NATIONS MOVE TOWARD THE MARKET SYSTEM

KEY TERMS

- **privatization**: The process of changing the ownership of the means of production from government ownership to private ownership (page 509)
- **welfare state**: A blend of capitalism and socialism that relies on markets to make most economic decisions but which provides government benefits to ensure the social equality of all citizens (page 510)

DRAWING FROM EXPERIENCE

Have you or anyone you know ever been the victim of “downsizing”? This is when companies reduce costs by eliminating jobs that they do not consider to be absolutely necessary. How do you feel about downsizing? Do you think companies should keep competent workers that they can get along without—or should they fire perfectly good employees so that they can lower costs and operate more efficiently? This question has concerned workers and managers throughout the world, as nations privatize sectors of their economy that have long been run by the government. This section focuses on the movement toward free markets in Russia, Sweden, and Latin America.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Circle or check the correct response. Think about how moving toward free markets—and from free markets to a command economy—affects jobs and productivity.

<table>
<thead>
<tr>
<th>Change</th>
<th>Unemployment</th>
<th>Productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>From: command economy</td>
<td>will increase</td>
<td>will increase</td>
</tr>
<tr>
<td>To: market system</td>
<td>will decrease</td>
<td>will decrease</td>
</tr>
<tr>
<td>From: market system</td>
<td>will increase</td>
<td>will increase</td>
</tr>
<tr>
<td>To: command economy</td>
<td>will decrease</td>
<td>will decrease</td>
</tr>
</tbody>
</table>

READ TO LEARN

- **Privatization in Russia** (page 509)

A centralized command economy lasted for 74 years in the Soviet Union until that nation’s economic and political system collapsed in 1991. Since then, ownership of business and production resources has passed from the state to private hands in a process called *privatization*. When privatization takes place, disruption can also occur. When private owners take over state-run industries, they often make production more efficient. As a result, some workers may lose their
jobs. For this reason, many Russians have resisted privatization. Some have even demanded a return to the old system of centralized planning.

Under the old system, government officials set prices. These often were too low, which resulted in severe shortages of many necessities. Today, the law of supply and demand sets most prices in Russia. High demand has caused prices to increase, causing many Russians to continue going without necessities—this time because they cannot afford them.

In 1998 the Russian economy fell into serious decline. Many state-owned industries had been sold at bargain prices to friends of the government. In addition, at least half the economy was operating on a barter system because businesses had no faith in Russian currency. The barter system also allowed businesses to avoid paying taxes, which were so high that companies could not pay them and still stay in business.

1. Why would a switch to capitalism result in Russian workers losing their jobs?

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**Changes in Sweden** (page 510)

Sweden has been a blend of capitalism and socialism known as a **welfare state**. Such a system combines private ownership of the means of production with the goal of social equality for all citizens. In Sweden it has created a nation with one of the highest per-capita incomes in the world. For example, in the 1970s the government passed a law practically guaranteeing lifetime employment. Government takeovers of many large industries also helped to provide full employment.

By the 1990s, however, government spending (and taxes) accounted for about 4 percent of Sweden’s economic activity. Sweden began to change its economic and social welfare system. The government cut taxes, eliminated some public-sector jobs, eased regulations, and ended its monopolies in some industries. Sweden plans to move further toward a market system in the future.

2. How would government take-over of industries help guarantee full employment?

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**Changes in Latin America** (page 511)

Although the economic systems of most Latin American countries operate under market capitalism, most have had large government sectors. Since 1985, however, many government businesses have been privatized. For example, Chile has privatized its airlines and phones, while Argentina has sold its state-run oil fields and petrochemical plants. Since the mid-1980s these and similar countries have experienced high rates of economic growth.

3. Why would privatization encourage economic growth?
CHARACTERISTICS OF DEVELOPING NATIONS

KEY TERMS

- **developed nations** Nations with relatively high standards of living and economies based more on industry than agriculture (page 518)
- **developing nations** Nations with little industrial development and low standards of living (page 518)
- **subsistence agriculture** Growing just enough food by a family to take care of its own needs. No crops are available for export or to feed an industrial workforce (page 519)
- **infant mortality rate** Death rate of infants who die during the first year of life (page 520)

DRAWING FROM EXPERIENCE

When someone asks you to think about a developing country, what images come to mind? How do you think people live in developing countries? Do all people within a developing country have the same standard of living? Are there any similarities between the way that people live in a developing country and the U.S.?

In this section you will learn how developing nations use foreign investment and aid to move through the three stages of economic development.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the economic characteristics of developing nations.

**Characteristics of Developing Nations**

READ TO LEARN

- **Developed vs. Developing Nations** (page 518)

Of the more than 192 nations in the world, only about 35 are considered developed nations. Most of the world's population lives in developing nations. These nations have relatively low standards of living and are less developed industrially. Developing nations differ in many ways. Income levels between countries vary greatly. Great differences in standards of living also exist within developing nations. India's urban population lives much like people in developed nations, but some of its rural population may not have enough to eat.
1. Are all developing nations alike? Why or why not?

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**Economic Characteristics** *(page 519)*

Developing nations generally share five characteristics.

1. **Low GDP** Developing nations may have many natural and human resources, but they lack the equipment, financing, and knowledge necessary to put those resources to use.

2. **An Agricultural Economy** Agriculture is central to the economies of developing nations. Most of the population exists through subsistence agriculture. Each family grows just enough food to take care of its own needs. Consequently, no crops are available for export or to feed an industrial workforce.

3. **Poor Health Conditions** Developing nations suffer from a shortage of modern doctors, hospitals, and medicines. Many people die from malnutrition or illness due to lack of food. Low life expectancy for adults and high infant mortality rates are common. Infant mortality rates measure the number of infants that die during their first year of life.

4. **Low Literacy Rate** Relatively few people in developing nations can read or write. Governments lack resources to build and maintain schools. Children miss school to help their families farm. A poorly educated workforce is difficult to train for needed technical and engineering jobs.

5. **Rapid Population Growth** Overpopulation is the source of serious problems, such as a shortage of food and housing. Populations in developing nations sometimes grow as much as four times the rate of developed nations.

2. Which of these five characteristics do you think is the most threatening to a developing nation’s standard of living? Why?

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**Weak Property Rights** *(page 521)*

Weak property rights hinder development. Without defined private property rights, individuals cannot exchange land. Consequently, large-scale farming does not develop. Peasant families have little incentive to improve the value of the property on which they farm.

3. Why do weak property rights hinder development?
**THE PROCESS OF ECONOMIC DEVELOPMENT**

**KEY TERMS**

- **nationalization** A process where government takes over ownership of railroads, businesses, or other industries (page 525)
- **foreign aid** Money, goods, and services given by governments and private organizations to help other nations and their citizens (page 525)
- **economic assistance** Loans and outright grants of money to other nations to add to their capital resources (page 525)
- **technical assistance** Aid supplied by nations to teach skills to individuals in other nations. Professionals, such as engineers, teachers, and technicians, usually provide this assistance (page 525)
- **military assistance** Economic or technical aid given to a nation’s armed forces (page 525)

**DRAWING FROM EXPERIENCE**

What can you do if you need more money? In what ways can you obtain money?

In this section, you will learn how developing nations use foreign investment and aid to move through the three stages of economic development.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about why nations give foreign aid.

---

**The Process of Obtaining Aid for Development**

**Sources of Capital**

1. 
2. 

**Who Supplies Foreign Aid**

1. 
2. 

**Reasons for Giving Foreign Aid**

1. 
2. 
3. 
4. 

---

**READ TO LEARN**

**Financing Economic Development** (page 524)

Economic development passes through the three stages of agricultural, industrial, and service sector development. Usually, developing nations cannot finance economic growth from domestic
savings. People living in traditional economies do not engage in the type of savings that provide a pool of financial capital from which businesses can borrow for investment. Developing nations seek outside sources of capital from two general sources.

A. **Foreign Investment** Investors are attracted to developing countries because of their low wages, few regulations, and abundant raw materials. Political instability and the threat of nationalization are serious risks. **Nationalization** is a practice among developing nations of taking control of private firms.

B. **Foreign Aid** Foreign aid is the money goods and services given by governments and private organizations to help other nations. **Economic assistance** in the form of loans and outright grants has played an increasingly important role in economic development. **Technical assistance** strengthens a nation’s human resources by providing professions, such as engineers, teachers, and consultants to teach skills. **Military assistance** involves giving either economic or technical assistance to a nation’s armed forces. Emergency aid is not directed at development. It provides food, clothing, and medical supplies to victims of disasters.

1. What are the two general sources of outside capital that developing nations seek?

**Who Supplies Foreign Aid** (page 526)

Several developed nations and international organizations offer foreign aid. After World War II, the U.S. devoted most of its foreign aid to rebuilding Europe’s war-torn economies. Today, most U.S. foreign aid is sent to developing nations in the Middle East and Southeast Asia. When foreign aid is viewed as a percentage of GDP, the U.S. provides a fraction of what many other nations give. Organizations like the U.S. Agency for International Development and the International Bank for Reconstruction and Development, also called the World Bank, help to distribute foreign aid. Developing nations sometimes find themselves unable to repay their foreign debt. Forty nations owe nearly $127 billion to the IMF and World Bank.

2. Why are some international aid organizations concerned about foreign debt?

**Reasons for Giving Foreign Aid** (page 527)

Governments and private agencies provide aid for four basic reasons.

1. **Humanitarianism** The relief of human suffering is a major goal of many private organizations.

2. **Economics** It is usually in the best interest of developed counties to encourage international trade. Foreign aid provides markets for exports and investment opportunities.

3. **Politics** Foreign aid builds political friends and broadens the appeal of some government forms.

4. **Protect a nation’s security** Economic aid is often a down payment on a military alliance.

3. Why do nations give foreign aid?
OBSTACLES TO GROWTH IN DEVELOPING NATIONS

KEY TERMS

bureaucracies Offices and agencies of the government that each deal with a specific area (page 530)
capital flight The legal or illegal export of currency or money capital from a nation by that nation’s leaders (page 530)

DRAWING FROM EXPERIENCE

Have you ever tried to take care of a plant or a pet? What tasks did you have to perform? Do all plants or pets require the same care? Why do some plants or pets need different care?

In this section you will learn why developing nations have not followed the same path of recovery as Europe did in the 1940s.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the four obstacles to growth faced by developing nations.

Four Obstacles to Growth

READ TO LEARN

Four Obstacles to Growth (page 529)

The successful rebuilding of Europe’s economy following World War II convinced many economists that injections of money capital into a nation could achieve rapid economic growth. Europe already had a skilled labor force, advanced organizations, such as corporations, and experienced government bureaucracies. These are specialized offices and agencies. Developing nations do
not possess these characteristics. They suffer from four obstacles to growth.

1. **Attitudes and Beliefs** People in developing nations often live and work much as their ancestors did. Innovation is often viewed with suspicion, and attitudes are slow to change.

2. **Continued Rapid Population Growth** If the population grows faster than GDP, standards of living will fall along with per capita GDP.

3. **Misuse of Resources** Developing nations sometimes choose to spend money for defense rather than agricultural development. **Capital flight** is another misuse of resources. Its leaders may legally or illegally export local currency from a nation. If new leaders take over they often inherit crushing debt from such corruption.

4. **Trade Restrictions** Tariffs and quotas are used to limit imports that compete with domestic industries

1. What are the four obstacles to growth in developing countries?

---

**Case Study: Indonesia (page 531)**

Following independence in 1949, Indonesia seemed well equipped for economic growth. It possessed an abundant population, rich mineral resources, vast oil reserves, valuable farmland, and $2 billion worth of foreign aid. The economy was a disaster, however, for several reasons. Problems with divided nationalities, religion, and politics sometimes resulted in violent clashes. In 1965, General Suharto produced strong economic growth by relying on oil and agricultural exports. The 1980s world “oil glut” and falling prices for farm products slowed economic growth. In 1997-1998 Southeast Asia’s economic crisis caused Indonesia’s economy to collapse. Suharto later resigned under suspicion of misuse of funds.

2. What problems interfered with Indonesian industrialization?
INDUSTRIALIZATION AND THE FUTURE

KEY TERMS

vicious cycle of poverty A situation that keeps developing countries trapped in poverty. A less-developed country with low per capita incomes cannot save and invest enough to achieve acceptable rates of economic growth (page 536)

DRAWING FROM EXPERIENCE

Have you ever tried to put something together without following the instructions? Did you make any mistakes? Did you have the right equipment to perform the task? Did anyone try to tell you about a better way to do it? How did you feel when the other person gave you advice?

In this section, you will learn that attempts at rapid industrialization can prove a wasteful use of scarce resources.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the four reasons why rapid industrialization often fails.

Problems of Rapid Industrialization

READ TO LEARN

Problems of Rapid Industrialization (page 535)

There are four problems of rapid industrialization.

1. Unwise Investment Developing nations invest in areas where they do not have a comparative advantage. Citizens receive less economic value from their resources than they would have received from other investments.
2. **Not Adapting to Change** If a population does not have time to adapt to new patterns of living and working, large numbers of people may be displaced from their homes. Many will migrate to already overcrowded cities.

3. **Using Inappropriate Technology** Balanced growth requires the use of technology that is suitable for a culture. The benefits of industrialization can be more widely distributed by undertaking smaller, rather than larger, technological changes.

4. **Rushing Through the Stages of Development** Many economists believe that time allows nations to adapt successfully to different stages of development. Gradual change permits nations to increase incomes, savings and the number of skilled workers necessary to support the next stage of development.

1. What are the four problems with rapid industrialization?

---

**Economic Development** *(page 536)*

Foreign trade, an appropriate incentive structure, a supportive political structure, availability of natural resources, and a reduced population growth influence economic development. If a nation lacks one of these factors, they are not necessarily trapped in the *vicious cycle of poverty*. The vicious cycle of poverty presumes that developing nations are poor because they cannot save and invest, but they cannot save and invest because they are poor. Development normally depends on entrepreneurs who are able to perceive opportunities and then take advantage of them. However, risk taking will not occur if the political system does not permit risk takers to be rewarded. This requires well established property rights and no fear that government will nationalize businesses. The more certain property rights are, the more investment there will be.

2. How can the vicious cycle of poverty be overcome?

---

**Information Leads to Cooperation** *(page 537)*

Information about the higher standards of living in developed countries has convinced people in developing nations of the benefits of working together. These nations realize that they have little control over the world market unless they work together in the international economic community. Increased information has produced more cooperation between developed and developing nations. Global negotiations have promoted a more equal distribution of the world’s wealth and resources, low tariffs for developing nations, and an “income tax” on developed nations to pay for international assistance programs.

3. What role has information played in encouraging economic development?
Reasons for and Results of Global Integration

Key Terms

- **global integration**: Interdependency among the countries of the world, especially within financial markets and telecommunications (page 544)
- **telecommunications**: Long-distance communication, usually electronic, using communications satellites and fiber-optic cables (page 544)

Drawing from Experience

Have you ever communicated with someone over the Internet who lived in a different country? Have you ever bought an item that was made in a country other than your own?

This section explains how we are all part of a global economy. Particularly, it focuses on how telecommunications inventions have helped to create global financial markets.

Organizing Your Thoughts

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the number of telecommunications products in your household.

<table>
<thead>
<tr>
<th>Telecommunications Inventions</th>
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<tbody>
<tr>
<td>1. ___________________________</td>
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<tr>
<td>2. ___________________________</td>
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<tr>
<td>3. ___________________________</td>
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<tr>
<td>4. ___________________________</td>
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</tbody>
</table>

Read to Learn

- **Improved Telecommunications** (page 544)

The United States is part of the global economy. There is evidence of this everywhere. Americans buy cars made in Japan, England, Mexico, or several other nations. Those countries are dependent upon the United States for revenues from their exports. This transaction illustrates the concept of **global integration**, or the interdependency among countries. Global integration has increased dramatically over the last few decades.
One of the main reasons for the increase in global integration is improved telecommunications. **Telecommunications** includes the first transatlantic telegraph cable completed in 1866 as well as communications satellites circling the earth every day. Thanks to these inventions, people all over the earth are able to communicate faster with one another than ever before. Other significant telecommunications inventions have been the computer chip and the Internet. These inventions also have contributed to the increase in global integration.

How does global integration affect people in other countries? Suppose teenagers in India are watching American television programs such as MTV. As a result, Indian teenagers want to buy the same fashions they see on MTV. Indian clothing manufacturers start copying American fashion designs.

1. How have advances in telecommunications contributed to global integration?

---

**The Globalization of Financial Markets** *(page 545)*

As stated before, recent telecommunications inventions have increased the speed of communication between people all over the world. These same telecommunications inventions also have made it possible for banks to develop worldwide branch networks for loans and foreign exchange trading. Before the first transatlantic telegraph in 1866, it took two weeks to find out the price of the dollar in London. Today, currency is exchanged worldwide in the time it takes to send an e-mail message. In fact, foreign exchange, or the buying and selling of foreign currencies, is a 24-hour worldwide market. Other worldwide financial markets exist for government securities (bonds that the United States government sells) and other commodities such as grains, gold and silver, and stocks.

There also is a worldwide stock market, but it has had some problems. On October 19, 1987 the Dow Jones Industrial Average (DJIA) fell 508 points. The DJIA is a measuring system that tracks stock prices over the long run. When the DJIA fell 508 points, foreign investors started selling their stocks. This caused other foreign stock markets to crash, too. Foreign investors also started selling stock they owned in the United States stock market. It became a vicious cycle of selling. It took two years for the United States’ stock market to recover. It took longer for most foreign markets to recover. In other words, there are pros and cons to having a globalized financial market.

2. What financial markets have become worldwide?
DIRECT FOREIGN INVESTMENT—SHOULD WE BE WORRIED?

KEY TERMS

direct foreign investment The purchase by foreigners of real estate and businesses in another country (page 549)

DRAWING FROM EXPERIENCE

Have you ever eaten at Burger King? Did you know that Burger King is British-owned? Did you know it was possible for foreign people and businesses to purchase American companies? This section focuses on how foreign investments can play an important role in a country’s economy.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the benefits and drawbacks of foreign investment in a country’s economy.

<table>
<thead>
<tr>
<th>Direct Foreign Investment in the U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pro</strong></td>
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<tr>
<td></td>
</tr>
</tbody>
</table>

READ TO LEARN

- Foreign Investment, Then and Now (page 549)

Foreigners have been investing in United States businesses for many years. In fact, Great Britain was the biggest investor in the railroad expansions of the late 1800s. One way in which foreigners invest in the United States is through direct foreign investment, or the purchase of real estate and businesses. Foreigners invest billions of dollars in American businesses and real estate every year. Oftentimes, political upheaval in their own nations makes foreigners want to invest in the United States. One of the main reasons for foreign investment in the United States is its political stability. Political stability helps promote economic stability. Foreigners living in politically unstable countries want to protect their money by investing in a more stable economy than their own.
Most economists believe the desire to make a profit is common throughout the world. In other words, foreign investors, like American investors, invest in American businesses in order to maximize profit. Some Americans argue against foreign ownership of American businesses. Their argument is that foreign owners of American businesses might gain too much control. For instance, foreigners own 38 percent of all United States government securities. Can foreigners use this to control United States foreign policy? Probably not. It is more likely that foreigners buy United States government securities simply to maximize profits. Also, when foreigners invest in United States government securities or private corporate securities, it allows United States business leaders to use their capital for other productive uses.

Foreign investors might indirectly influence United States government. For example, if the United States government were to make it difficult for foreigners to invest in American businesses, then foreign investors would take their money elsewhere. As a result, American businesses would not benefit from obtaining foreign capital. Hence, they would not have that foreign capital available for improving and expanding their businesses.

1. What might happen if the United States government made it difficult for foreigners to invest in American businesses?

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2. How do countries benefit from direct foreign investment?

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Investment Here and Abroad (page 550)

Foreigners own only about 6 percent of American industries. In Great Britain, 20 percent of that country’s total sales come from companies owned by foreigners. In comparison, foreign investments in the United States are fewer than those in many other countries.

On the other hand, the United States’ share of worldwide direct investment is more than 40 percent. In some foreign countries, the United States has been accused of economic imperialism. The term economic imperialism is used to describe what happens when one country, say country ABC, invests so much money in another country, say country XYZ, that country XYZ’s culture begins to resemble the culture of country ABC.

However, most economists argue that countries benefit from direct foreign investment. This is true because foreign investors have an interest in seeing the economies in which they invest remain strong. For instance, foreign investors in United States real estate do not want real estate prices in the United States to collapse. Also, foreign investors in United States businesses want the United States to remain politically stable. This is true because a politically stable country usually has a stable and thriving economy. Finally, foreign investors in United States businesses want those businesses to compete effectively so that the investors’ investments become profitable.

2. How do countries benefit from direct foreign investment?
MULTINATIONALS AND ECONOMIC COMPETITION

KEY TERMS

*multinationals* Firms that do business and have offices or factories in many countries *(page 553)*

*foreign affiliates* Branches of multinational firms *(page 554)*

DRAWING FROM EXPERIENCE

Are you aware that more and more companies have branches or factories in many different countries? For instance, did you know that Japanese car manufacturers like Toyota and Honda have factories in the United States as well as in Japan and other countries?

This section explains how some corporations set up businesses in many different countries and regions.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about why it might be beneficial for a car company to manufacture cars in several different countries.

**Regional Investments**

1. U.S. multinationals invest in ____________________________
2. EU multinationals invest in ____________________________
3. Japanese multinationals invest in ____________________________

**Examples of Alliances**

1. 
2. 

Multinationals
**READ TO LEARN**

**The Size and Number of Multinationals (page 554)**

*Multinationals* are companies that do business or have offices or factories in many countries. In the 1970s, many people believed that a few hundred multinationals would control 80 percent of the world’s production by the mid-1980s, but that did not come to pass. By 2003, there were approximately 60,000 multinationals. These multinationals operated about 620,000 *foreign affiliates*, or branches of their firms.

According to the best estimates, the largest 100 multinationals control 15 percent of the world’s production. Americans, Japanese, Germans, and Swiss own about half of the 60,000 multinationals. A growing number of multinationals are based in the industrializing nations of Asia, such as Taiwan, South Korea, and Malaysia.

1. What is a multinational?

**Regional Cross-Border Investments (page 556)**

Most multinationals invest in regions close to home. For instance, most American multinationals invest in the United States, Canada, Mexico, and South America. Likewise, most Japanese multinationals invest in Japan, South Korea, China, and Southeast Asia. And most members of the European Union and Switzerland invest in western Europe.

2. In what countries do most American multinationals invest?

**Beyond Multinationals—Alliances (page 556)**

Another way in which companies can conduct direct foreign investment is by forming alliances. These alliances are agreements between foreign and domestic firms. An example of an alliance might be a joint venture in which two firms develop a new product together. Another example might be a licensing agreement in which a foreign firm might license a domestic firm to sell the foreign firm’s product. Most alliances are formed between firms in industrialized countries.

An alliance can be very beneficial. For example, suppose one firm has financial and technological limitations. That firm can form an alliance with another firm that has more available capital and more sophisticated technology. With more capital and sophisticated technology, the firm can compete more effectively in the market.
3. How can a firm benefit from forming an alliance with another firm?

________________________________________________________________________

________________________________________________________________________

[ The Global Village and Tolerance (page 557) ]

The population of America is more diverse today than ever before. In the 1980s, the Asian population in America increased more than 100 percent. In 2003, Hispanics became the largest minority group in the United States. This increase in immigration is one of the results of the globalization of the world. In such a diverse culture, it is important that people are tolerant of one another and more open-minded. For Americans this means maintaining friendships with people of different ethnic, cultural, national, and/or religious backgrounds.

4. What is one of the results of the globalization of the world?

________________________________________________________________________

________________________________________________________________________
THE GROWTH OF E-COMMERCE

KEY TERMS

- **microchip** A tiny electronic circuit that processes and digitally transfers information (page 565)
- **cybernomics** An economic system driven by Internet commerce (page 566)
- **Internet** A worldwide system of interconnected computers that store, process, and share information (page 566)
- **World Wide Web** Part of the Internet that is used for communication among consumers, business, governments, and other organizations (page 566)
- **Web site** An electronic location on the World Wide Web that stores information for Web users to view or download (page 566)
- **e-commerce** Electronic commerce on the Internet (e-business) (page 567)
- **frequency marketing** Marketing directed by stored information about the frequency of a customer’s use of a product (page 568)

DRAWING FROM EXPERIENCE

Have you ever spent part of a day or an evening looking for a present for a relative or friend? You trudge from store to store at the mall, or even drive to stores around town, searching for the perfect gift. Perhaps you would have been better off to have stayed at home and shopped on the Internet. But what if the recipient does not like your present? How would he or she exchange a gift bought on the Internet for something else?

This section focuses on how computers, the Internet, and the World Wide Web are changing the nature of commerce throughout the world.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about differences between e-commerce and traditional distribution systems.

![Diagram of Traditional System vs. E-Commerce System]
READ TO LEARN

Introduction (page 565)

The tiny electronic circuit known as the microchip is one of the greatest advances of our lifetime.

Business on the Internet (page 566)

The microchip has stimulated the use of computers and computer networks such as the Internet to the point that some people believe we have entered the age of cybernomics—an economic system driven by the Internet. In 1994 about 3 million people worldwide were connected to the Internet. By 1998, that figure had grown to more than 82 million. Information on the World Wide Web, the most popular part of the Internet, also grew in amount and in the number of Web sites. These are electronic locations on the World Wide Web that store information to be viewed or downloaded into the viewer's computer.

Web sites have changed the entire business landscape by allowing businesses to directly reach customers. Companies that have carefully built supply chains find that anyone using the Web can bypass those chains. New companies can spring up on the Web nearly overnight to compete with well-established traditional businesses.

E-commerce, or electronic business, is risky. Planners must decide among many possible business models. Combinations of advertising, subscriptions, fees, and direct sales can produce huge profits or huge losses. Yet most managers believe that the Internet will have a major impact on the global marketplace. Traditional businesses must go online if they are to remain competitive.

1. How does having a Web site change the business landscape?

The Customer Wins (page 568)

E-commerce shifts the balance of power to customers by allowing them to more easily comparison shop and gather information about products and vendors. Relationships among producers, wholesalers, distributors, retailers, and consumers are also changing. Consumers can deal directly with producers on the Internet. Also new middlemen are springing up on the Web with allegiance to the buyer rather than to the producer.

2. Why does e-commerce make it easier for consumers to comparison shop?

A Marketing Revolution (page 568)

Many producers are bypassing regular channels of trade and are reaching out to customers directly. Through frequency marketing, a business's computer can gather and store information about a customer's wants. Then, on future visits to the business's Web site, the customer can be offered products based on this information. In addition, a business can use its Web site to assist customers by e-mail and to link them to sources of goods, services, or information.

3. How does frequency marketing help businesses to better serve customers?
KEY TERMS

telecommunications  Communications over long distances which are assisted by technology (page 571)
Information Age  The period when telecommunications and computer technology gave information significant economic value (page 571)
knowledge economy  An economy in which information is the key to growth (page 572)
weightless economy  An economy based on products that are not tangible (page 572)
innovation  Development of new products, processes, or systems that have wide-ranging effects (page 573)

DRAWING FROM EXPERIENCE

Have you visited the Economics Today and Tomorrow Web site? You may have downloaded some of the materials that you found there. However, despite your use of them, these materials remain available to you and to students across the nation. Your textbook will wear out from use, but the information on the Web site can be accessed over and over without being used up. This is just one way the Internet has changed how we measure the value of a product.

This section focuses on how innovation has affected economic growth.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about the innovations and technologies that have spurred periods of rapid economic growth.

<table>
<thead>
<tr>
<th>Date</th>
<th>Innovation that spurred economic growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1785</td>
<td></td>
</tr>
<tr>
<td>1845</td>
<td></td>
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<tr>
<td>1900</td>
<td></td>
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<tr>
<td>1950</td>
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<tr>
<td>1990</td>
<td></td>
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</table>

READ TO LEARN

Introduction  (page 571)

Telecommunications, or electronic communications, includes radio, television, satellite uplinks, and cable access. The computer has revolutionized the handling and storage of information. The joining of the two technologies has produced dramatic results. Many people believe that the new
environment the merger created—called the Information Age—will have as great an effect on humankind as the Industrial Revolution

The Knowledge Economy (page 572)

The terms “knowledge economy” and “weightless economy” describe an environment in which ideas and information—stored in libraries, databases, and videos—are as valuable as tangible goods.

Knowledge products, such as computer software, are quite different from other products. First, they are not physically used up by consumers. In fact, the more often they are used, the more valuable they become to the consumer. Second, knowledge products have no geographic limitations. For example, people around the globe can simultaneously use the same software on a computer server. Third, a knowledge product includes both the product and the idea behind it. For example, when you buy a database program, you are purchasing both the disk (the product) and the programming (the idea) that allows you to organize data. Even if knowledge products are expensive to develop, after the original is built, thousands of copies can be cheaply reproduced.

The influence of the knowledge economy can be measured by its effect on people and nations. For example, information and communications technology firms are the growth leaders in the U.S. economy. Computer-related jobs will increase more than 70 percent in a ten-year period.

1. In what two ways does use of a knowledge product differ from the use of other products?

A Change or a Revolution? (page 572)

Some economists believe that the “new” economy is not really so revolutionary. They point out that rapid growth in productivity has generally accompanied major new ideas. For example, the harnessing of electricity and the invention of the automobile each spurred a period of expansion.

For years, economists believed that the output of an economy could generally be measured by the effect of two basic inputs—capital and labor. Yet this explanation did not fit several large bursts of economic growth in history. Economist Joseph Schumpeter was the first to suggest a relationship between innovation and the business cycle. He studied long business cycles and concluded that each new cycle or wave of expansion started when a set of innovations—such as waterpower for industrial machines (1785), steam locomotives (1845), and electricity and the internal combustion engine (1900)—came into general use. After his death, other economists used his model to add two more waves: the age of petrochemicals, electronics, and aviation (1950) and the merger of telecommunications and computers (1990).

Economists face challenges whether the “new economy” is revolutionary or simply the old economy plus the innovation factor. In a rapidly changing system, they must try to predict the future in order to advise policymakers about the job market, economic development, and other vital issues.

2. What argument can be made that the economy created by the Information Age is not really a “new economy”? 
ISSUES IN CYBERNOMICS

**KEY TERMS**

- **day trading** Buying and selling securities rapidly over the Internet (page 577)
- **intellectual property** Creations of a person’s mind, such as writings and music, that are protected by copyright laws (page 577)
- **consumer-credit laws** Laws passed to protect consumers by giving them access to their credit records (page 578)
- **distance education** Education provided by telecommunications technology (page 578)

**DRAWING FROM EXPERIENCE**

Are your course grades, standardized test scores, and other school records in paper files at your school or does your school keep this information on a computer database? Which form of record-keeping do you think provides the most protection from theft, destruction, or unauthorized changes to your permanent record?

This section focuses on the social, economic, and political issues raised by the growth of computers and the Internet.

**ORGANIZING YOUR THOUGHTS**

Use the diagram below to help you take notes as you read the summaries that follow. Think about how the World Wide Web and E-mail help a nation’s government and its people to exchange information and ideas.

```
from:  
a. ____________  

Web Site  
Information

to:  
b. ____________  

to:  
c. ____________  

E-mail  
Ideas

to:  
d. ____________  
```

from:  
a. ____________  

Web Site  
Information

to:  
b. ____________  

to:  
c. ____________  

E-mail  
Ideas

to:  
d. ____________  
```
READ TO LEARN

Ensuring Safe Internet Trade (page 576)

The Internet has reduced the cost of entry for companies wanting to sell goods and services. A modest outlay for a computer server is about all that is needed to start a business on the Web. Although major companies with name recognition have an advantage in the area of consumer trust, new companies can quickly catch up.

One of the fastest-growing forms of online commerce is securities trading. People can use the Internet to buy and sell stocks and bonds anywhere in the world. Some of them are engaging in a risky practice called day trading. They use computers and Internet connections to buy and quickly resell stock in hopes of making a profit. Such people may make or lose a lot of money very quickly. The government must balance people's right to a free market with the need for consumer protection.

1. Why might a consumer want to be wary of a retailer on the Internet that he or she has never heard of and knows nothing about?

Protecting Intellectual Property (page 577)

The Internet has made protection of intellectual property—creations that come from someone's mind—more difficult. Some Internet sites offer visitors downloadable copies of other people's software or recorded music. This deprives the rightful owners of the product the ability to profit from their ideas. Stealing intellectual property reduces the incentive to be creative. Software, music, and other companies are developing systems to prevent the illegal distribution of their products over the Internet.

2. Why is a music CD both a physical property and an intellectual property?

Protecting Consumer Privacy (page 578)

Advances in computing have made it possible to collect all kinds of information about people. Information such as your purchases at a store, telephone calls, credit history, and health records can become part of large databases of information. The availability and sharing of this information raises issues of security and personal privacy. Businesses are trying to police the use of such information themselves, so that the government will not pass privacy legislation. Security software attempts to keep hackers and thieves from accessing bank accounts and other important information.

3. How might a bank robbery occur over the Internet?
### Developing Nations (page 578)

Some economists believe that information and communications technologies will help developing countries to “leapfrog” stages of development. For example, cell phones and wireless technology will allow communications with rural areas more quickly than if wired networks must be built. Such technology can allow countries to take advantage of **distance education**, connecting teachers with students in remote areas via telecommunications.

Other economists believe that the information revolution will widen the gap between developing and industrialized countries. They point out that the gap in schooling between developing and industrialized nations is even greater in computer education. Developing countries also often have less appreciation for intellectual property rights.

4. Why would lack of respect for intellectual property rights slow a nation’s development?

Governments will have to deal with all the issues discussed in this section. However, at the same time it creates issues, the Information Age allows citizens to be informed about them and to keep in touch with their leaders so that wise decisions on these issues can be made.

5. How do computers make it easier for citizens and their leaders to communicate?