

American Free Enterprise

GUIDE TO READING

Section Preview

In this section, you will learn how under capitalism the basic economic decisions of WHAT, HOW, and FOR WHOM to produce are made through the free interaction of individuals looking out for their own best interests.

Content Vocabulary

- free enterprise (p. 48)
- voluntary exchange (p. 49)
- private property rights (p. 50)
- profit (p. 50)
- profit motive (p. 50)
- competition (p. 50)
- consumer sovereignty (p. 51)
- mixed or modified free enterprise economy (p. 53)

Academic Vocabulary

- incentive (p. 50)
- catalyst (p. 51)
- regulator (p. 52)

Reading Strategy

Listing As you read the section, complete a graphic organizer like the one below to identify the five characteristics of a free enterprise economy. Then provide an example of each.

Characteristic	Example

COMPANIES IN THE NEWS

Hot Growth at Claire's

When Bonnie and Marla Schaefer became vice-CEOs of Claire's Stores Inc., they had much to prove to the company's board. Within a few years they did just that: profits nearly doubled, earning Claire's a slot on *BusinessWeek's* 2005 list of Hot Growth companies.

How did the sisters do it? One way was to focus on a troubled recent acquisition they renamed Icing. The new store appeals to the 17-to-27 crowd. Unlike their father, Rowland Schaefer, founder and former CEO of Claire's, the sisters use market research to identify teen trends. They also licensed popular celebrities such as Mariah Carey to provide cosmetics and jewelry lines.

The sisters won't stop there. The company already has stores in Europe and Japan, and franchises are now expanding into other continents. ■



—adapted from *BusinessWeek*

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apitalism has become the economic system of choice in many parts of the world because of its ability to generate wealth, just as it has for Claire's. Capitalism, as you have learned, is an economic system in which private citizens own and use the factors of production to generate profits.

The U.S. economy is based on free enterprise. Under free enterprise, resources are

privately owned, and competition is allowed to flourish with a minimum of government interference. We often use the terms *capitalism* and *free enterprise* interchangeably, but they have different meanings. While capitalism stands for the private ownership of resources, free enterprise is the unhindered use of privately owned resources to earn profits.

Characteristics of Free Enterprise Capitalism

MAIN Idea

The American economy incorporates the main characteristics of a free enterprise economy.

Economics & You How much freedom do you have to make your own economic choices? Read on to learn how this freedom characterizes our own market economy.

A capitalistic free enterprise economy has five important characteristics: economic freedom, voluntary exchange, private property rights, the profit motive, and competition.

Economic Freedom

Economic freedom means more than being able to buy the things you want. It means that you have the freedom to choose your occupation, your employer, and your job location. You can even leave your current

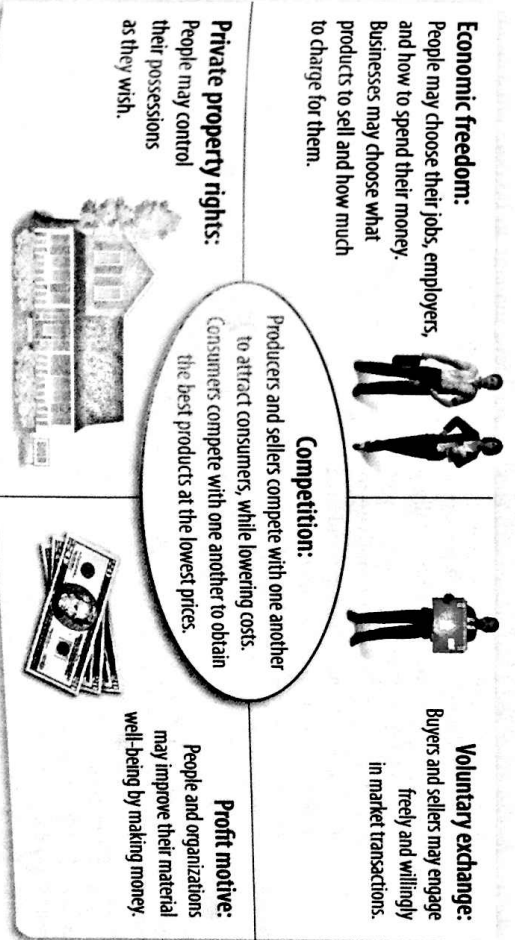
job and move on to another job that offers greater opportunity. Businesses also enjoy considerable economic freedom. They are free to hire the best workers, and they are free to produce the products they feel will be the most profitable. Businesses can make as many items as they want, sell them wherever they please, and normally charge whatever price they choose. In short, they are free to risk success or failure.

Voluntary Exchange

A second characteristic of capitalism is **voluntary exchange**—the act of buyers and sellers freely and willingly engaging in market transactions. Voluntary transactions benefit both the buyer and the seller, or the exchange would never occur. For example, when buyers spend their money on a product, they act on a belief that the item they purchase is of greater

Figure 2.3

Characteristics of Free Enterprise Capitalism



“Free enterprise capitalism” describes a market economy in which private citizens own the factors of production and businesses compete with minimal government interference.

Economic Analysis What items are included in the category of private property?

private property rights fundamental feature of capitalism that allows individuals to own and control their possessions as they wish

profit extent to which persons or organizations are able to improve their financial position at the end of a period than they were at the beginning

profit motive incentive that encourages people and organizations to improve their financial position and material well-being

competition the struggle among sellers to attract consumers

Personal Finance Handbook

See pages A6-A9 for more information on saving and investing.

value than the money they give up—or they would not make the purchase. When sellers exchange their products for cash, they believe that the money they receive is more valuable than the product they sell—otherwise they would not make the sale.

Private Property Rights

Another major feature of capitalism is **private property rights**, which allow people to own and control their possessions as they wish. People have the right to use or even abuse their property as long as they do not interfere with the rights of others.

Private property gives people the **incentive** to work, save, and invest. When people are free to do as they wish with their property, they are not afraid to accumulate, improve, use, or lend it. They also know they can keep any rewards they might earn.

Profit Motive

Under free enterprise capitalism, people are free to risk any part of their wealth in a business venture. If it goes well, they will earn rewards for their efforts. If it goes poorly, however, they could lose part or all of their investment.

Profit is the extent to which persons or organizations are better off financially at the end of a specific period than they were at the beginning. The **profit motive**—the incentive that encourages people and organizations to improve their material well-being—is largely responsible for the growth of a free enterprise system.

Competition

Capitalism thrives on competition—the struggle among sellers to attract consumers. Competition is possible because individual entrepreneurs have the freedom to produce the products they think will be the most profitable. Free enterprise capitalism allows competition to flourish, benefiting both producers and consumers alike.

Check Your Understanding Summarizing How does voluntary exchange work in the free enterprise economy?

The Role of the Entrepreneur

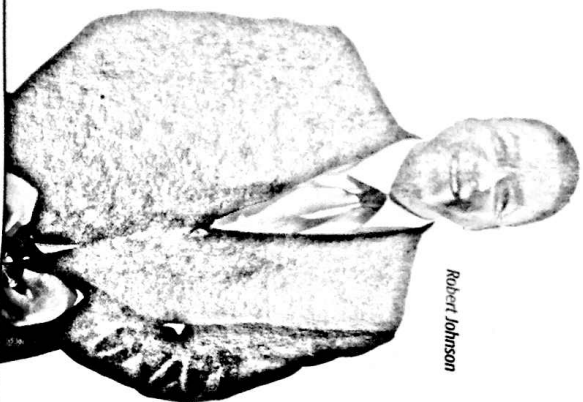
MAIN Idea Entrepreneurs are the driving force of the free enterprise system.

Economics & You Can you think of a successful entrepreneur and the business he or she runs? Read on to learn why entrepreneurs are important in a free enterprise economy.

The entrepreneur plays one of the most important roles in the free enterprise economy. The entrepreneur organizes and manages land, capital, and labor in order to seek the reward called profit.

Entrepreneurs are the people who start up new businesses such as restaurants, automobile repair shops, Internet stores, and video arcades. They include people who may have worked for others at one time, but who decided to quit and start their own businesses. Entrepreneurs want to “be their own boss” and are willing to take risks to make their dreams come true.

Many entrepreneurs fail. Others survive and manage to stay in business with varying degrees of success. A few, and only a very few, manage to become fantastically wealthy. Well-known entrepreneurs include Robert Johnson, founder of BET,



Robert Johnson

Bill Gates, who founded Microsoft, and Mary Kay Ash, who founded Mary Kay Cosmetics.

Despite the high rate of failure among entrepreneurs, the dream of success is often too great to resist. The entrepreneur is both the spark plug and the catalyst of the free enterprise economy. When an entrepreneur is successful, everybody benefits. The entrepreneur is rewarded with profits, a growing business, and the satisfaction of a job well done. Workers are rewarded with more and better-paying jobs. Consumers are rewarded with new and better products. The government is rewarded with a higher level of economic activity and larger tax receipts that can be used to build roads, schools, and libraries for people not even connected with the original entrepreneur. It does not stop there. Successful entrepreneurs attract other firms to the industry who rush in to “grab a share” of the profits. To remain competitive and stay in business, the original entrepreneur may have to improve the quality of the product or cut prices, which means that customers can buy more for less. In the end, the entrepreneur’s search for profits can lead to a chain of events that brings new products, greater competition, more production, higher quality, and lower prices for consumers.

Reading Check Analyzing Why are entrepreneurs considered both spark plugs and catalysts of the free enterprise economy?

The Role of the Consumer

MAIN Idea The economy in the United States adapts to consumers’ wants.

Economics & You When you go shopping and cast your dollar “votes,” do you realize that you are helping to answer the question of WHAT to produce? Read on to learn how consumers help decide what products are offered in a free market economy.

Consumers have power in the economy because ultimately they determine which products are produced. If consumers like a new product, the producer will be rewarded with profits. If consumers do not buy it, the firm may lose money or even go out of business. The term **consumer sovereignty** recognizes the role of the consumer as sovereign, or ruler, of the market. The phrase “the customer is always right” reflects this power.

In recent years, producers have had outstanding successes with products ranging from video games to Internet search engines such as Google. Other products—including “Crystal” Pepsi, celery-flavored Jell-O, and Dr. Care’s aerosol toothpaste (which kids discovered they could spray around the bathroom)—were rejected.

In addition, consumers’ wants change constantly as people are exposed to new ideas and products. Today, Americans purchase more home computers every year than TV sets, even though computers were

consumer sovereignty role of consumer as ruler of the market when determining the types of goods and services produced

Skills Handbook See page R40 to learn about Analyzing Information.



photo: Hot dog stand in Los Angeles

Entrepreneurs and Consumers Some entrepreneurs, like Robert Johnson, develop corporations for consumers nationwide, while others serve local customers. How do consumers influence the economy?

Resolving Trade-Offs Among Goals

MAIN Idea Conflicts among goals can be solved by comparing the cost of a goal to its benefit.

Economics & You You learned earlier about trade-offs when deciding how to spend a monetary gift of \$100. Read on to find out how trade-offs also apply to economic goals.

People often have different ideas about how to reach a goal, or the goals themselves might conflict. Even our economic policies have opportunity costs.

For example, a policy that keeps foreign-made shoes out of the United States could help achieve the goal of full employment in the domestic shoe industry, but it could work against individual freedom if people have fewer choices of shoes to buy.

Even an increase in the minimum wage involves a conflict of goals. On one hand, supporters of the increase argue that an increase is the equitable, or "right," thing to do. Opponents argue that an increase may cause fewer workers to be hired. In addition, it restricts the freedom of employers to pay wages that they think are fair.

How are trade-offs among goals resolved? In most cases, people compare their estimate of the costs to their estimate of the benefits, and then vote for political candidates who back their position. If the majority of voters feel that the minimum wage is too low, then it will be raised. The minimum wage then tends to stay at this new level until the majority of people feel that it needs to be changed again.

People, businesses, and government are usually able to resolve conflicts among goals. Fortunately, the economic system of the United States is flexible enough to allow choices, **accommodate** compromises, and still satisfy the majority of Americans.

In a democratic society, government reflects the will of a majority of its people. As a result, many government functions reflect people's desire to modify the economic system to achieve their economic goals. A program such as Social Security, as well as laws dealing with child labor and the minimum wage, reveal how Americans have modified their free enterprise economy. This system most likely will undergo further change as the goals and objectives of the American people change.

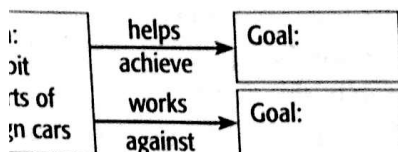
✓Reading Check Explaining Why do trade-offs among goals exist?

Review

the significance of minimum wage, Social Security, inflation, and fixed income.

why it is important for a nation to set economic goals.

Defining Cause and Effect Use a graphic organizer like the one below to illustrate how economic and social goals may conflict with one another.



Critical Thinking

- The BIG Idea** How does an increase in the minimum wage involve a conflict of goals?
- Inferring** What can Americans do to influence the economic goals of the nation?
- Applying** How do laws against false or misleading advertising promote the goal of economic equity?

Applying Economics

- Economic Security** Interview a friend or relative who is retired or approaching retirement to find out if he or she believes the government has achieved the goal of economic security for its senior citizens, and why. Write a paragraph to describe these views and explain why