

# Reading Essentials and Study Guide



## Chapter 3: The American Free Enterprise System

### Lesson 1 American Free Enterprise Capitalism

#### ESSENTIAL QUESTION

*What are the benefits of a free enterprise economy?*

#### Reading HELPDESK

##### Academic Vocabulary

**incentive** something that motivates

##### Content Vocabulary

**free enterprise** an economic system in which privately owned businesses have the freedom to operate for a profit with limited government intervention

**voluntary exchange** economic action done or brought about by free choice

**private property rights** fundamental feature of capitalism, which allows individuals to own and control their possessions as they wish; includes both tangible and intangible property

**profit** extent to which persons or organizations are better off at the end of a period than they were at the beginning; usually measured in dollars

**profit motive** driving force that encourages people and organizations to improve their material well-being; characteristic of capitalism and free enterprise

**competition** the struggle among sellers to attract consumers

**biofuels** fuel made from wood, peat, municipal solid waste, straw, corn, tires, landfill gases, fish oils, and other waste

**Great Recession** severe economic downturn that lasted from late 2007 through mid-2009

#### Key Ideas and Details

Use a graphic organizer like the one below to compare the benefits and disadvantages of a free enterprise economic system.

Benefits of Free Enterprise	Disadvantages of Free Enterprise

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#### Characteristics of Free Enterprise Capitalism

**Guiding Question** *How does the American economy incorporate the main characteristics of a free enterprise economy?*

*Capitalism is an economic system in which private citizens, like you, own and use the factors of production. Individuals or companies make products and profits. If the products can be bought and sold without government regulation or control, we have a condition called a free market.*

If an economy has both capitalism and free markets, we say that the economy is based on free enterprise. Under **free enterprise**, resources are privately owned. Competition is allowed with a minimum (least amount) of government controls.

People often use the terms *free enterprise*, *free market*, or *capitalism* to describe the economic system of the United States. A free enterprise economy has five important characteristics. They are: economic freedom, voluntary (willing) exchange, private property rights, the profit motive, and competition. Some of these features may already be familiar. However, these features are so important to the success of our economy and the way we live that it's important to review them.

#### 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 career, your employer, and your job location. You can even leave your job and move to another one.*

Businesses also enjoy a good deal of economic freedom. They are free to hire the workers of their choice. They are free to produce the products they think will be the most profitable. Businesses can make as many items as they want. They can sell them wherever they please. And, normally, they can charge whatever price they choose. In short, they are free to risk success or failure.

Think how much different life would be under a different economic system. There are few choices under a traditional economic system. This is because you would do the same things in the same ways as your elders did. Under a command economy, you would do what the leaders want, not what you want. Under a system guided by socialism, you work for the benefit of the state. Only a free market system gives you the type of freedom you enjoy today.

#### Voluntary Exchange

*A second characteristic of capitalism is **voluntary exchange**. This is when buyers and sellers freely and willingly make market transactions (purchases or sales). A voluntary exchange benefits both the buyer and the seller, or it would never occur.*

For example, when buyers purchase a product, they act on a belief that the item is of at least the same value as the money they paid. They would not buy the item if it were not worth the money. Sellers sell their products for cash because they believe that the money is more valuable than the product they sell, or they would not make the sale.

In a command economy or some mixed socialist economies, consumers are not able to exchange things freely. This is because there are so few markets available. Also, a command or mixed socialist economy is so much less efficient than a market economy. Therefore, there may not be many products to exchange.

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The logo for 'networks' features the word 'networks' in a bold, sans-serif font. The letter 'o' in 'networks' is replaced by a stylized globe icon with several lines radiating from it, suggesting a network or global connectivity.

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#### Private Property

Another major feature of capitalism is **private property rights**. These allow people to own and control their possessions. People even 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**, or push, to work, save, and invest. When people are free to do as they wish with their property, they are not afraid to build up, improve, use, or lend it. They also know they can keep any rewards they earn. The U.S. Constitution protects the private property rights of the American people.

Private property makes borrowing possible and investing attractive. If you own property, you can use the property as collateral (a guarantee of repayment), if you need to take out a loan. If you want to invest in a business, there will be a record of your investment to prove that you are an owner. Both these activities—borrowing and investing—are much more difficult in a command or a socialist economy, if they happen at all.

#### 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. If it goes poorly, they will lose their investment. **Profit** is the amount by which persons or organizations are better off financially at the end of a specific period than they were at the beginning. The **profit motive** is the incentive to increase one's wealth. It is largely responsible for the growth in a free enterprise system.

The freedom to seek profits helps to guarantee that there is an endless stream of producers who want to offer the best products at the lowest prices. Some firms are entering industries for the first time. Others may be leaving one industry and entering another. Not all succeed. But the lure of profits is the single most important thing that drives production.

In a command economy, there is no profit motive to encourage businesses to produce. This is because the WHAT to produce question is guided by the government. The government is much more likely to keep under-performing companies going, rather than move resources to other, more useful activities.

#### Competition

Capitalism thrives on **competition**—the struggle among sellers to attract the most consumers. Competition is possible because businesses and entrepreneurs have the freedom to produce what they think will be the most profitable. Free enterprise capitalism allows competition to thrive. This benefits both producers and consumers.

Competition benefits consumers by ensuring that unpopular products will cease to be produced. Competition also benefits consumers by ensuring that producers always work to bring newer, better, and less expensive products to market.

Competition benefits the economy by ensuring that the most efficient producers of a product survive, while the least efficient producers fail or try to produce different products. In a world of scarce resources, competition helps to ensure that resources are used as efficiently as possible.

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#### Reading Progress Check

**Explaining** How do private property rights serve as an incentive in a free enterprise economy?

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## Benefits of Free Enterprise Capitalism

**Guiding Question** *How does a free enterprise economy provide opportunities for individuals?*

### Individual Freedom

*Individual freedom is almost the same as the “economic freedom” described earlier, so in some ways the two overlap. Economic freedom is both a trait and a benefit of capitalism. This is true of capitalism in the United States. It is also true in other parts of the world, like Singapore and Northern Europe. Capitalism and democracy are fairly strong in those places.*

Our individual freedom shows in many different ways, from choices we make in the market to choices we make in the voting booth. Strong and stable democracies are also found in countries with free enterprise capitalism. It is not possible to have one without the other.

Freedom is something that we value every day, from the time we get up until the time we go to bed. Many of the personal choices we make, such as the foods we buy and the jobs we do, would not be possible without an economy based on free enterprise capitalism.

### A Variety of Goods

*Market economies everywhere produce a huge variety of goods of almost all shapes, colors, and sizes. Take shoes, for example. Whenever you go into a shoe store, you will find an amazing variety of colors, styles, shapes, and sizes. If the store is big enough, there may be aisles and aisles of shoes, and the variety of shoes changes from season to season. Go to a different store, and you might find different brands, colors, and styles. All this is due to competition. But think how different things would be in a different type of economy.*

Under a command economy, as in the former Soviet Union, the central planners would solve the problem of shoe production in a different way. First, they would get an estimate of the number of men, women, and children in the economy. Then they would decide how many pairs of shoes each should buy in a year. The easiest thing is to make a small number of styles, in a limited number of colors. The result, as far as the consumer was concerned, was a handful of styles that were produced mostly in one color—black.

### Exploring the Essential Question

*In a free enterprise economy, businesses may be subject to government regulation. However, they are not controlled by the government. Consider the following situation. A business called Beta becomes*

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*very successful. It moves into a larger space. Then it opens more and more stores around the city, and offers lower prices than its competitors. Many of the competing firms begin to go out of business. Eventually, Beta is the only store where people can shop. Should the government prevent Beta's domination of the market so that there are other places where people can buy the things they want? Write a paragraph explaining your answer.*

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### Adapting to Change

*Market economies adjust daily to change. The adjustment takes place mainly through the price system, and a change in the price of one product can affect changes in other industries. Consider the way the rising cost of oil on international markets has affected our economy. One of the main changes has been increased gas mileage for new cars. Because there is a growing focus on fuel efficiency, car makers have figured out how to improve mileage. More efficient gasoline engines and lighter weight materials for car bodies have been developed. Some of the improvement is also due to extensive wind tunnel testing to reduce wind drag.*

Other changes have also taken place because of the rising price of oil. Wind farms have popped up all over the country to turn wind into electricity. Solar energy is also being harnessed. **Biofuels** are fuels made from renewable materials. Buildings are now becoming much more energy efficient, costing less to heat and cool. All these changes were driven by the higher price of oil.

These changes are often difficult to observe day by day, but when observed over longer periods, they are significant. In the end, it is the market economy that helps us adjust.

Things would be different if the United States had a command economy. In a command economy, central planners regulate the domestic distribution of oil. That might seem as though it should help keep the supply and price reliable. However, the government buys oil on international markets at one price, and then distributes it to consumers at a much lower price. Government budgets make up the difference. None of the energy-efficient changes takes place because the quantity of oil stays fairly constant. If oil supply or demand changes, then central planners might impose solutions such as not driving on weekends. They might not encourage the innovation (creative improvement) necessary to create fuel-efficient cars.

### Promoting Progress

*In a free market economy, business and entrepreneurs are allowed to freely enter markets and compete for consumers. This competition generally results in a continuing supply of newer and better products. For proof of this, consider the recent development in the markets that affect you the most.*

For example, consider the cellphone industry. It seems to offer newer and better products almost monthly. Cell phones are now available from a number of different companies, in a variety of sizes and shapes. The phones also have different features that change almost daily. These include apps that let your phone run GPS connections, work as an MP3 player, a game player, and a flashlight. The list goes on and on. Computer tablets have evolved rapidly, too.

All this progress is possible because of the intense competition among firms to attract consumers. The competition takes the form of better products and, usually, lower prices—both of which promote progress.

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#### Creation of Wealth

*Economists think of wealth as the build-up of products that are tangible, have utility, and are transferable. The creation of wealth is exactly what happens when more and better products are produced in a free market capitalistic system.*

The United States' Gross Domestic Product (GDP) (the dollar value of all final goods, services, and structures produced within a country's borders in a year) is the largest in the world. It is twice as large as China's GDP, even though China's population is more than four times larger than the U.S. population.

There is no question that an economic system based on free market capitalism is the most efficient wealth-generating system. The success of the United States has not been lost on other nations. It is one of the main reasons why so many other nations have a free market system—or are changing to one.



#### Reading Progress Check

**Explaining** How does the free enterprise system allow for the ability to more easily adapt to changing economic conditions?

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#### Disadvantages of Free Enterprise Capitalism

**Guiding Question** *What are the weak points of the free enterprise economy?*

*Free enterprise capitalism is not without some drawbacks. Of course, they are relatively minor when compared to problems with other types of economies. But still, they exist.*

#### Uneven Economic Growth

*The growth of free enterprise capitalism is not always smooth and uninterrupted. Sometimes the growth is relatively fast, while at other times it takes a step back. Most recently, the U.S. economy went through what is now called the **Great Recession**. This started in December of 2007 and lasted until mid-2009. During this 18-month period, the nation's GDP shrank by between 5 and 7 percent.*

Periods of uneven economic growth are not pleasant, but they do remove some of the "fat" (unnecessary activities) in the economy. Even with these painful periods, free market capitalist systems still outperform other economic systems like tradition, command, or socialism by a wide margin.

#### Growing Gaps Between Rich and Poor

*Another disadvantage of free enterprise capitalism is that the rich seem to get richer while the poor seem to stay poor, or even get poorer. While this will be discussed in greater detail in a later chapter, federal data on income support this observation.*

Some of this is due to the fact that some people—if they are able to come up with a product that meets a consumer need—can grow very rich in a very short period of time. There may not be many solutions to this issue. Tax policies and social welfare programs do attempt to redistribute income from the wealthy to the poor. However, many Americans do not approve of these measures. They believe



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that these measures are not fair to those who made a lot of money. Still, if the gap gets too wide, voters may demand that government do something about it.

#### Large “Supply-Side” Tendencies

*Economists know that free enterprise economies work best when there are a large number of buyers and sellers on both sides of the market. This is not a problem on the demand side of the market. This is where the number of participants seems to grow as more and more people start to search for and buy products. Your parents may have done most of their shopping in a small local market with a few thousand other buyers. You, however, may join millions of other buyers to purchase the same products nationally.*

The supply side of the market is completely different. This is because suppliers tend to combine with other suppliers to avoid competition and get rid of overlapping operations. For example, the Carnival Corporation is a company that owns Carnival Cruise Lines, Holland America, Princess Cruises, Seabourn in North America, and also Costa Cruises in Southern Europe. The competition among these companies is probably not very fierce since they are all part of the same corporation.

When similar firms combine, the result is fewer participants on the supply side of the market. Meanwhile, the participants on the demand side of the market are now focused on a smaller number of suppliers. This is one result of capitalism. It is a result that makes competitive markets less efficient. It is one of the reasons why the government may step in if one company has too much control of a single market. However, the government does not often stop firms from combining and reducing competition.

#### Rights and Responsibilities of Business

*You may not realize it, but businesses have most of the same rights as individuals. They can sue and be sued, they can enter into contracts, and they can own property, just like you. About the only thing that corporations can't do is vote.*

In addition to these rights, businesses also have many responsibilities. These are due to government regulations that limit the scope of their activities. For example, the federal Immigration and Nationality Act (INA) requires that all employees be treated equally. It is illegal for businesses to have a “U.S.-citizens-only” hiring policy, unless citizenship is required by a federal, state, or local law, or by government contract.

Other government regulations protect consumers against harm from products on the market. These products range from baby car seats to cars, to medicines, and more. These regulations are required by the Consumer Product Safety Commission that was established in 1972. Regulations like these are unique to free enterprise capitalism. They are not found in other types of economic systems. They exist because citizens have the power through voting to force the government to act to protect consumers. So “free enterprise” is usually not completely “free.”



#### Reading Progress Check

**Explaining** How do the “supply-side tendencies” in a free enterprise economy tend to work to the disadvantage of the consumer?

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