

## CHAPTER

# 3

### SECTION 1

Advantages of the Free Enterprise System

### SECTION 2

How Does Free Enterprise Allocate Resources?

### SECTION 3

Government and Free Enterprise

### CASE STUDY

The United States: Land of Entrepreneurs

# The American Free Enterprise System

## CONCEPT REVIEW

A **market economy** is an economic system based on individual choice, voluntary exchange, and the private ownership of resources.

## CHAPTER 3 KEY CONCEPT

**Free enterprise system** is another name for capitalism, an economic system based on private ownership of productive resources. This name is sometimes used because in a capitalist system anyone is free to start a business or enterprise.

## WHY THE CONCEPT MATTERS

Free enterprise is all around you, from huge suburban malls to industrial developments to neighborhood corner stores. Think about ways that the American economic system affects your day-to-day life. Consider where you shop, what you buy, where you work, and what you do there. What do you think allows this huge economic engine to run?

## Online Highlights

More at [ClassZone.com](http://ClassZone.com)

### Economics Update

Go to **ECONOMICS UPDATE** for chapter updates and current news on entrepreneurs in the United States. (See Case Study, pages 92–93).

### Animated Economics

Go to **ANIMATED ECONOMICS** for interactive versions of diagrams in this chapter. ▶

### Interactive Review

Go to **INTERACTIVE REVIEW** for concept review and activities.



How do households, businesses, and government interact in the economy? See Figure 3.4 in Section 2 of this chapter.

# Advantages of the Free Enterprise System

## OBJECTIVES

- In Section 1, you will
- explain why the United States is considered to have a capitalist, or free enterprise, system
  - identify the legal rights that safeguard the free enterprise system
  - analyze how the profit motive and competition help to make the free enterprise system work

## KEY TERMS

- free enterprise system, *p. 70*  
 open opportunity, *p. 73*  
 legal equality, *p. 73*  
 free contract, *p. 73*  
 profit motive, *p. 73*

## TAKING NOTES

As you read Section 1, complete a cluster diagram using information on free enterprise. Use the Graphic Organizer at **Interactive Review @ Classzone.com**



## What Is a Free Enterprise System?

### QUICK REFERENCE

**Free enterprise system** is another name for capitalism, an economic system based on private ownership of productive resources.

### KEY CONCEPTS

As you recall from Chapter 2, the United States has a capitalist economic system. Capitalism is an economic system based on the private ownership of the factors of production. The central idea of capitalism is that producers are free to produce the goods and services that consumers want. Consumers are influenced by the desire to buy the goods and services that satisfy their economic wants. Producers are influenced by the desire to earn profits, the money left over after the costs have been subtracted from business revenues. A capitalist system is also known as a **free enterprise system** because anyone is free to start a business or enterprise.

### EXAMPLE United States

Let's take a look at one American who took advantage of that freedom. Monica Ramirez, a makeup consultant for fashion magazines and television, noticed that very few Hispanic women purchased the cosmetics available in stores. She thought that this might present a business opportunity. So, in 2001, she created Zalia Cosmetics, a line of cosmetics specifically for

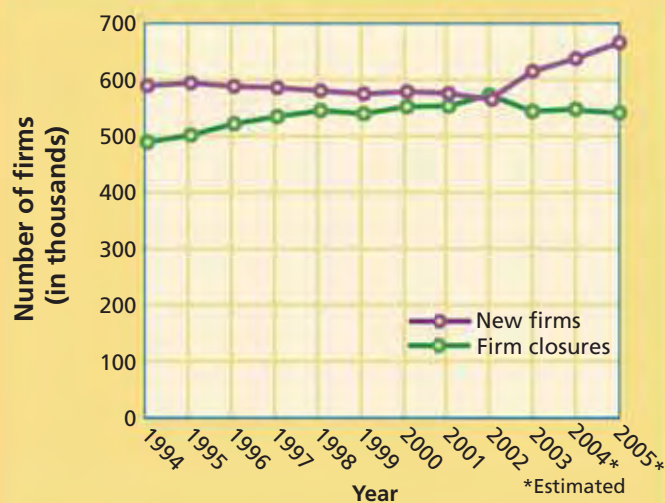


Latinas. She put her whole savings account into starting the business. Her creativity and energy attracted attention, and she soon had backers willing to invest their money in the business.

By 2004, Zalia Cosmetics had sales outlets in the major Hispanic markets of New York, Miami, Dallas, Los Angeles, San Antonio, and Houston. Today, the business continues to grow and Ramirez is sharing her success. She donates a percentage of her profits to organizations that help and encourage Latina entrepreneurs.

As you can see in Figure 3.1 below, Zalia Cosmetics was just one of more than 585,000 new businesses started in the United States in 2001. No matter where you go in the United States, you can see similar signs of a free enterprise economy at work. If you walk through a suburban shopping mall you'll see national and regional chain stores next to small boutiques and startup shops. Sometimes you'll even see kiosks in the aisles, competing for business. Similarly, on a stroll through a city neighborhood you'll observe corner grocery stores, dry cleaners, and barber shops. At an industrial park you'll see factories that churn out an immense variety of products. In the countryside beyond the city, you'll notice farms with fields of corn or soybeans, orchards of apples or peaches, or grazing areas for livestock.

**FIGURE 3.1 NEW FIRMS AND FIRM CLOSURES**



Source: U.S. Small Business Administration

This line graph shows the risk involved in starting a new business. Nearly as many businesses close as the number of new businesses that start each year. Less than half of all new businesses survive for four years or more.

**Economics Update**

Find an update on new business firms and business firm closures at [ClassZone.com](http://ClassZone.com)

**ANALYZE GRAPHS**

1. What is notable about 2002 in terms of the relationship between new firms and firm closures?
2. How does this graph illustrate the fact that entrepreneurship involves risk?

What do these examples of free enterprise have in common? They are all illustrations of how individual choices are the basis of a market economy. Business owners freely make the choice to start these enterprises. Also, these owners are free to choose how they will use their scarce productive resources. The managers and workers who operate these businesses voluntarily decide to exchange their labor for the pay the owners offer. Finally, consumers make their own choices on which goods and services they will buy.

As you recall, government plays a relatively limited role in the American free enterprise system. The government sometimes takes actions that limit free enterprise. For the most part, however, these actions are designed to protect or encourage competition or to enforce contracts.

### EXAMPLE Emerging Markets

As you read in Chapter 2, most countries today have mixed economic systems with at least some elements of free enterprise. Each economy has its own balance of tradition, free enterprise, and government involvement and its own distinctive ways in which market forces work. To illustrate this, let's look at the countries of Mexico and Singapore

In the Mexican economy, the government plays a much larger role than in the United States. The Mexican government has established many rules and regulations that make starting a new business quite difficult. As a result, an informal market that gets around these barriers has grown up. In Mexico City, for example, much of the city center is taken up with vendors' stalls, and people jam the streets to buy imported toys, clothing, shoes, CDs, and more at much lower prices than they could find at regular retail stores. Indeed, the stiff competition from street vendors has driven some of the retail stores out of business.

The country of Singapore has a thriving free enterprise system. However, the government is so closely involved in the economy that the country is sometimes called Singapore Inc. The government establishes what benefits employers must provide to workers. It also requires all workers to put a percentage of income in the Central Provident Fund, a government savings scheme. The fund is used to pay pensions and to finance public projects, such as education, housing, and health care. Even so, the government is considered very supportive of free enterprise. Many of its policies keep business rents, taxes, and other costs low so that Singaporean companies remain competitive in the world economy.



**Competition** Popular stalls on the streets of Mexico City, selling everything from candy to clothes, provide considerable competition for established stores.

### APPLICATION Analyzing Cause and Effect

A. What steps can a government take to support free enterprise?

# How a Free Enterprise System Works

## KEY CONCEPTS

You learned in Chapter 2 that the right to private property is one of the most fundamental freedoms in a capitalist economy. With that freedom comes the right to exchange that property voluntarily. This exchange lies at the heart of a free enterprise economy. Another key freedom of this type of economy is **open opportunity**, the ability of everyone to enter and compete in the marketplace of his or her own free choice. This ensures that the market will reflect a wide range of interests and talents and will provide incentives to everyone to be efficient and productive.

Free enterprise also requires **legal equality**, a situation in which everyone has the same economic rights under the law. In other words, everyone has the same legal right to succeed or fail in the marketplace. Another important element of a market economy is the **free contract**. For voluntary exchange to work, people must be able to decide for themselves which legal agreements they want to enter into, such as business, job, or purchase commitments.

These freedoms assure that people are able to engage in free enterprise. But what motivates people to start a business? For most people, it is the **profit motive**, the incentive that encourages people and organizations to improve their material well-being by seeking to gain from economic activities. Producers, motivated by profit, seek the highest possible price for their products. Competition offsets the drive to earn profits, since it forces prices down. This helps producers find a price that is not so high that it deters buyers and not so low that it inhibits profits.

## EXAMPLE Profit in Rocks

One memorable example of how the various economic freedoms and the profit motive come together in the free enterprise system is the pet rock. Talking with friends in April 1975, advertising executive Gary Dahl joked that regular pets were too much trouble. Pet rocks, he suggested, were much easier to care for. Dahl's friends were amused by the idea. In response, he wrote a manual on pet rocks, showing how they could be house trained and taught to do tricks.

In August, Dahl began packaging his pet rocks, complete with a care manual, for sale at gift shows. Intrigued, a buyer from a major department store ordered 500. In a matter of weeks, Dahl's joke had become a national story. Articles appeared in newspapers and magazines and Dahl did several interviews on television. By the end of the year, Dahl had sold more than two tons of pet rocks and had become a millionaire. However, as 1976 began, consumers lost interest, and it quickly became obvious that the pet rock was last year's fad. Dahl decided to get out of the pet rock business, guided by the same market forces that had brought him into the business and made him rich.

## QUICK REFERENCE

**Open opportunity** is the ability of everyone to take part in the market by free choice.

**Legal equality** is a situation in which everyone has the same economic rights under the law.

A **free contract** is a situation in which people decide which legal agreements to enter into.

The **profit motive** is the force that encourages people and organizations to improve their material well-being from economic activities.



### Open Opportunity

Because of legal rights built into the free enterprise system, Gary Dahl was free to enter the market for pet rocks.

**FIGURE 3.2** Free Enterprise and Legal Rights



**ANALYZE CHARTS**

The American free enterprise system is based on the idea of freedom—producers and consumers are free to pursue their economic self-interest. Certain legal rights have been established to protect and encourage this freedom. Reread the paragraphs on pet rocks on page 73 and those on books on pages 74–75. How do these examples illustrate the legal rights shown in this chart?

**EXAMPLE Competition over Books**

Gary Dahl did face competition from other producers who jumped into the pet rock market. Competition, however, did not drive him out of business. Rather, consumers simply stopped buying pet rocks. The market for books is somewhat different. Demand for books remains high, but booksellers have been going out of business because of new and fierce competition.

Before 1995, small chain stores and independent neighborhood booksellers dominated the book market. Around 1995, large chain stores such as Barnes & Noble Inc. and Borders Group Inc. began to compete more aggressively. Because of their huge purchasing volume, the large chain stores could buy their books at greatly discounted prices. They passed the savings on to consumers, lowering prices by anywhere from 10 percent to 40 percent. They also created a warm and welcoming atmosphere in their stores, with comfortable reading areas, cafés, and frequent readings and book signings by authors.

The tactics of the large chain stores caused problems for independent booksellers. In 1991, independent booksellers accounted for more than 30 percent of all book sales in the United States. By 2005, their share of sales had fallen to less than 15 percent. And between 1995 and 2005, about 1,200 independent booksellers went out of business.

Soon, however, the large chains faced a challenge themselves: Amazon.com. The online bookseller opened for business in July, 1995 and within a few months had become an important player in the book market. Amazon's easy-to-use Web site, huge database of titles, quick and reliable delivery, and discounted prices attracted many book buyers. By the end of 2004, Amazon's sales stood at \$134 million a week. Now Amazon, however, is looking over its shoulder at a new challenger. Online competitors such as Overstock.com and Buy.com have undercut Amazon's prices on hundreds of books by as much as 25 percent while matching Amazon's level of excellence in service.

Consumers have benefited from all of this competition, for they can now easily and conveniently buy books at the lowest prices. Those independent booksellers who have remained in business cannot match the lower prices offered by the large chains and online sellers. However, they can provide some things that their larger competitors cannot: personal service and a focus on local tastes or specialized subject areas. Consumers benefit from this, too. These independent booksellers who stayed in business illustrate an important aspect of free enterprise. Businesses that keep pace with changes in the market and adjust accordingly thrive. Those that do not eventually fail.

## YOUR ECONOMIC CHOICES

### FREE ENTERPRISE

#### Where will you open your restaurant?

You've decided to open a restaurant. You can lease one of two buildings. One is in a busy mall next to a highway exit. However, there are already six restaurants in that mall. The other location is in a small strip mall in a quiet neighborhood with no other restaurants nearby. Consider the chance to make profits and the level of competition, and choose.



Mall food court



Neighborhood strip mall

### APPLICATION Analyzing Cause and Effect

- B. Explain the chain of cause-and-effect reactions since the mid-1990s that led to lower book prices for American consumers.

# Milton Friedman: Promoter of Free Markets

## FAST FACTS

### Milton Friedman

**Born:** July 31, 1912

**Died:** November 16, 2006

### Important Publications:

*Capitalism and Freedom* (1962)

*Free to Choose* (1980)

*Bright Promises,*

*Dismal Performance: An Economist's Protest* (1983)

### Famous Quotation:

*I am in favor of cutting taxes under any circumstances and for any excuse, for any reason, whenever it's possible.*

### Major

### Accomplishments:

Economic advisor to Presidents Richard Nixon and Ronald Reagan, and to British prime minister Margaret Thatcher

At a glittering White House birthday celebration for Milton Friedman in 2002, President George W. Bush declared that the 90-year-old economist “has shown us that . . . in contrast to the free market’s invisible hand . . . the government’s invisible foot tramples on people’s hopes.” Economics professors are rarely guests of honor at White House galas. Why did Friedman receive such a tribute?

## Free to Choose

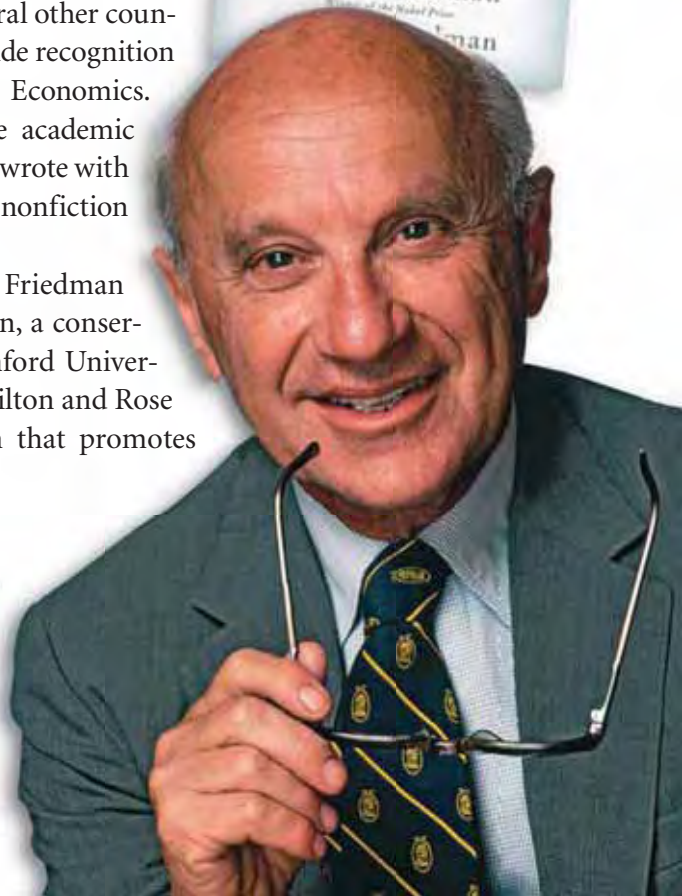
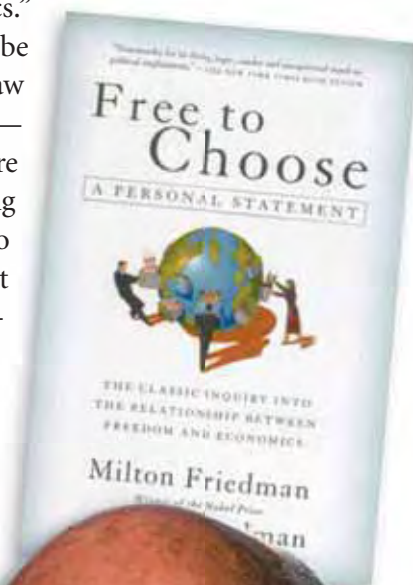
Friedman spent most of his career teaching at the University of Chicago, where he helped develop the free-market ideas now linked with what is called the “Chicago School of Economics.” Central to his ideas was the belief that the market should be free to operate in all fields, even such professions as the law and medicine. Easing government restrictions in these fields—lowering licensing standards, for example—would bring more doctors and lawyers into the market. This, in turn, would bring down the cost of legal and medical services. Friedman also put forward the theory that the government’s most important economic role was to control the amount of money in circulation. Without this control of the money supply, Friedman noted, the economy would experience inflation—a sustained rise in the general level of prices.

Friedman’s ideas were very influential. He advised two U.S. presidents and the heads of state of several other countries on economic policy. He gained worldwide recognition in 1976 when he won the Nobel Prize for Economics. Friedman became well known outside the academic world in 1980 when *Free to Choose*, which he wrote with his wife Rose, became the year’s best-selling nonfiction book in the United States.

From 1977 until his death in 2006, Friedman served as a scholar at the Hoover Institution, a conservative public-policy research center at Stanford University. In 1996, he and his wife founded the Milton and Rose D. Friedman Foundation, an organization that promotes school choice.

### Economic Freedom

Personal freedom is at the center of Friedman’s economic theories.



## Economics Update

Find an update on Milton Friedman at [ClassZone.com](http://ClassZone.com)

## APPLICATION Making Inferences

- C. How might Milton Friedman have responded to the problems associated with the informal market in Mexico?



# SECTION 1 Assessment

## REVIEWING KEY CONCEPTS

1. Explain the differences among the following terms.  
a. open opportunity      b. legal equality      c. free contract
2. What is the role of the profit motive in the American free enterprise system?
3. How is a free enterprise system linked to economic freedom?
4. Give examples of three different economic freedoms in a free enterprise system.
5. What force acts as a balance to the profit motive in the American free enterprise system?

6. **Using Your Notes** Write two or three paragraphs explaining how a free enterprise system works. Refer to your completed cluster diagram.

Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



## CRITICAL THINKING

7. **Applying Economic Concepts** Explain the role of competition in a free market. Illustrate your answer with examples of businesses in your local economy.
8. **Comparing and Contrasting Economic Information** Monica Ramirez and Gary Dahl both saw business opportunities and started new companies. Compare and contrast Ramirez's response to the market with that of Dahl. Use a Venn diagram to help you organize your ideas.
9. **Predicting Economic Trends** Turn back to page 74 and read again the paragraphs about competitive ideas in the bookselling market. What do you think might be the next new idea to compete with discounted books?
10. **Challenge** In a 1973 magazine interview, Milton Friedman said,  
*What kind of society isn't structured on greed? The problem of social organization is how to set up an arrangement under which greed will do the least harm; capitalism is that kind of a system.*

Do you agree with Friedman that societies are structured on greed and that capitalism can reduce the harm caused by greed? Explain your answer.

## ECONOMICS IN PRACTICE



A new business in the United States

### Analyzing Economic Information

The following chart gives data about the rules and time for setting up new businesses in six countries. The rules are measured according to the number of government procedures a new business has to go through before it can begin operating. The time is the number of days it takes to complete the process of registering a new business.

**Draw Conclusions** What is the relationship between the rules and the time for setting up a new business?

Country	Rules (Number of Procedures)	Time (Number of Days)
Canada	2	3
Sweden	3	16
United States	5	5
Singapore	6	6
Germany	9	24
Mexico	9	58
China	13	48

Source: World Bank, 2005

**Challenge** Use the chart and what you know about the economies of the listed countries to write a short paragraph comparing the ease of entry into the marketplace in three countries of your choice.

# How Does Free Enterprise Allocate Resources?

## OBJECTIVES

- In Section 2, you will
- explain how consumers help determine the way resources are used
  - explain how producers help determine the way resources are used
  - analyze a circular flow model of the U.S. economy

## KEY TERMS

profit, *p. 78*  
 modified free enterprise economy, *p. 80*

## TAKING NOTES

As you read Section 2, complete a cluster diagram to show how consumers, producers, and the government interact to allocate resources. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



## The Roles of Producers and Consumers

### KEY CONCEPTS

In the marketplace, consumers buy products for their personal use from producers who make or provide goods or services. In these exchanges, consumers look to get the best deal for the money they spend. Producers, on the other hand, are looking to earn the most profit from these transactions. **Profit** is the money left over after the costs of producing a product are subtracted from the revenue gained by selling that product. Seeking opportunities to earn profits is one way producers help allocate scarce resources in the economy.

### QUICK REFERENCE

**Profit** is the money left over after the costs of producing a good or service have been subtracted from the revenue gained by selling that good or service.

### EXAMPLE Producers Seek Profit

A new neighborhood coffee shop illustrates how producers help to allocate resources. The owners of the coffee shop, motivated by the desire to earn profits, charge the highest price consumers are willing to pay. The possibilities for good profits encourage other people to open coffee shops of their own. As a result, productive resources that might have been used in some other kind of business are directed toward the coffee shops. The profit seeking of producers, then, has helped in the allocation of resources.



## EXAMPLE Consumers Vote with Their Wallets

Consumers also play an important role in allocating resources in a free enterprise system. When consumers choose to buy a product, they are “voting” for their choice against competing products. These “votes” help determine what will be produced in the future, since producers, seeking opportunities to profit, try to provide what consumers want. For example, in the early 2000s, when low-carbohydrate diets were popular, consumers “voted” for low-carb and high-protein foods and against high-carb foods. (Figure 3.3 below illustrates this, showing that between 2002 and 2003 sales of typical low-carb/high-protein products increased, while sales of typical high-carb products fell.) How did food producers respond to these “votes”? They moved some of their productive resources into the low-carb market to try to meet consumer demand.

FIGURE 3.3 SALES OF SELECTED FOOD PRODUCTS

High-Carb Foods			Low-Carb/High-Protein Foods		
Product	Unit Sales, 2003 (in millions)	Percentage Change Over 2002	Product	Unit Sales, 2003 (in millions)	Percentage Change Over 2002
Instant Rice	79.1	-8.2	Frozen Meat/Seafood	483.5	+7.7
Bulk Rice	180.2	-4.9	Meat Snacks	105.4	+7.6
Cookies	1,839.7	-5.5	Nuts	679.3	+8.8
Regular Carbonated Drinks	7,032.5	-5.9	Diet Carbonated Drinks	2,828.6	+1.0
Dry Pasta	1,227.0	-4.6	Cheese	3,424.0	+4.0
White Bread	1,606.1	-4.7	Wheat Bread	873.1	+4.0

Source: ACNielsen

### ANALYZE TABLES

1. Which high-carb item showed the greatest percentage drop in sales between 2002 and 2003? Which low-carb/high-protein item showed the greatest percentage gain?
2. Consumer interest in low-carb diets began to decline after 2004. What differences might you expect to see in a similar table for 2004 and 2005?

Interest in low-carb diets peaked early in 2004, but began to fade thereafter. Once again, consumers had cast their votes in the marketplace, buying fewer low-carb and high-protein products. Producers quickly responded. By the beginning of 2005, some companies had gotten out of the low-carb market completely. Others had significantly cut back production of low-carb products. Consumer actions had caused a reallocation of productive resources.

## APPLICATION Analyzing Cause and Effect

- A. How would the allocation of resources have been affected if the interest in low-carb diets had continued to increase?

# Government in the U.S. Economy

## KEY CONCEPTS

### QUICK REFERENCE

A **modified free enterprise economy** is a free enterprise economic system with some government involvement.

In Chapter 2 you learned that the United States economy, though based on the market system, is mixed. Government is an important element in the American economic system, but its role is relatively limited. This type of mixed economy, which includes some government protections, provisions, and regulations to adjust the free enterprise system, is sometimes called a **modified free enterprise economy**.

## Modified Free Enterprise

In Figure 2.4 on page 53, you saw that the economy could be viewed as a stream of resources and products moving in a circular flow between households and businesses. Money also flows between households and businesses, facilitating this exchange of products and resources. Figure 3.4 shows how the government fits into this circular flow. It also shows how government exacts costs and dispenses benefits. Locate the two main economic decision-makers at the right and left of the chart: households (owners of resources) and businesses (makers of products). The two

FIGURE 3.4 Government in the Circular Flow Model



### ANALYZE CHARTS

This version of the circular flow model shows the flow of resources, products, and money among households, businesses, and the government. Describe the role of government in the economy using information from this chart.

**Animated Economics**

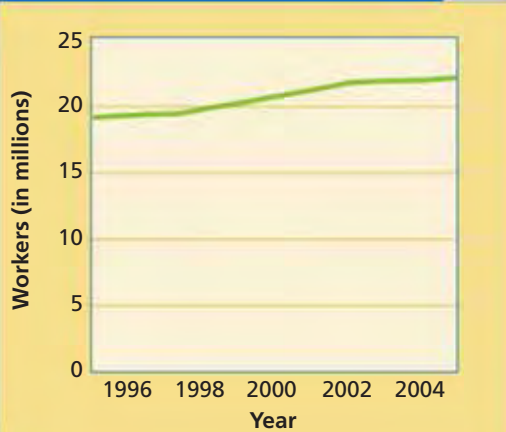
Use an interactive circular flow model at [ClassZone.com](http://ClassZone.com)

markets in the economy, the product market (for goods and services) and the factor market (for economic resources), are located at the top and bottom of the chart. The outer green arrows show the flow of money. The inner blue arrows show the flow of resources and products.

The government is located in the center of the chart. Like the other key actors in the circular flow, the government is both a consumer and a producer. Look at the arrows that run between government and the two markets. The government is a consumer in the resource market, spending money to buy the factors of production. It is also a consumer in the product market, spending money in exchange for products.

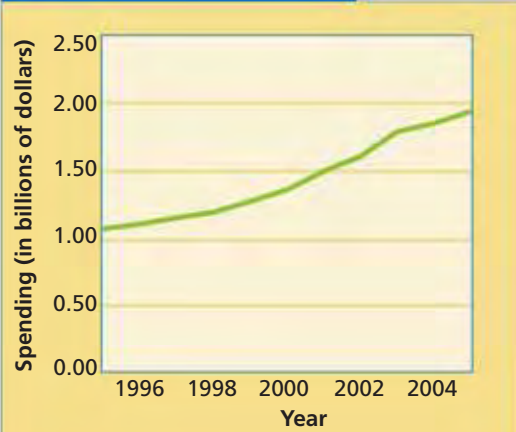
Now locate the arrows that run between government and households and government and business firms. Government is a producer here, providing goods and services to both households and businesses. Government collects money from households and businesses, in the form of taxes, as payment for these goods and services. It covers the costs of what it produces with this money. Government also uses this money to make purchases in the resource and product markets, and the cycle continues.

**FIGURE 3.5 WORKERS ON THE GOVERNMENT PAYROLL**



Source: U.S. Bureau of Labor Statistics

**FIGURE 3.6 GOVERNMENT CONSUMPTION**



Source: U.S. Department of Commerce

#### ANALYZE GRAPHS

1. About how many workers were on the government payroll in 2005?
2. Based on these two graphs, how is government's role as a consumer of products and resources changing?

Figures 3.5 and 3.6 above show that government is a major consumer of both resources and products. As you can see in Figure 3.5, all levels of government, local, state, and federal, employ almost 22 million workers. This is equal to about 16 percent of the labor force—all the labor resources available in the United States. Further, if you look at Figure 3.6 you'll see that government consumption—what all levels of government spend on goods and services—is about two trillion dollars.

#### Economics Update

Find an update on government workers and government consumption at [ClassZone.com](http://ClassZone.com)

### APPLICATION Applying Economic Concepts

- B. The paycheck that you get for working part-time at the pet store shows what you have earned and how much is withheld for taxes. Explain how the paycheck and the taxes withheld are represented in the circular flow model.



For more on interpreting graphs, see the Skillbuilder Handbook, page R29.

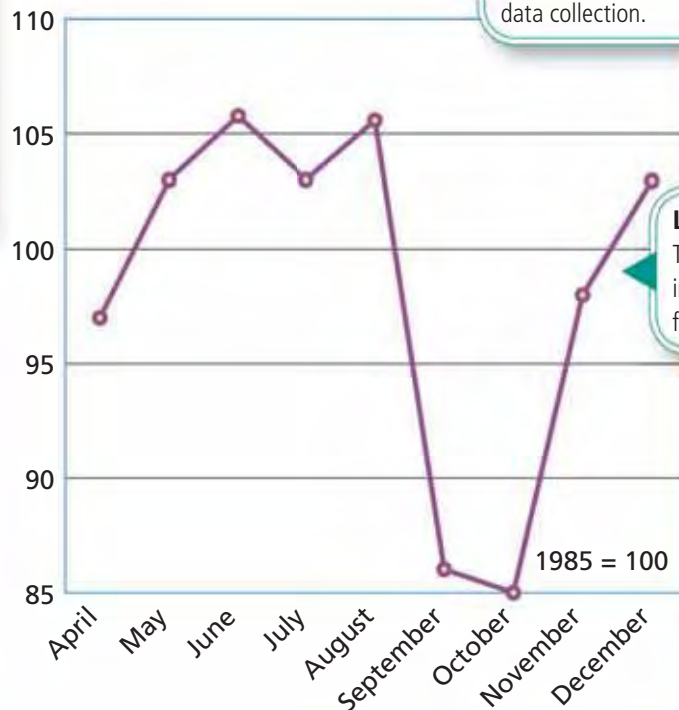
## Interpreting Graphs: Public Opinion Polls

Public opinion polls are a useful tool for gathering information. Economists frequently use information obtained from opinion polls to measure public response to economic conditions. Polls conducted at regular intervals show changes in public opinion over a given period of time. The graph below shows the results of a poll that tracks consumer confidence. The poll, which is conducted monthly, is based on a representative sample of 5,000 households in the United States.

**Title** This indicates the type of data shown. Consumer confidence refers to the way people feel about the economy. Increasing confidence is likely to result in increased purchases of goods.

**Consumer Confidence Index  
April–December 2005**

**Subtitle** This indicates the months and year of data collection.



**Line on Graph**

This shows the fluctuations in consumer confidence from month to month.

**Legend** This provides a benchmark for comparison. For example, scores higher than 100 indicate that consumers have more confidence in the economy than they did in 1985.

Source: The Conference Board, December 2005 Consumer Confidence Index

According to researchers, consumer confidence in the economy tumbled after Hurricane Katrina hit the Gulf Coast in September 2005. Falling gasoline prices and growth in the job market led to a recovery in confidence in November and December.

### THINKING ECONOMICALLY Interpreting

1. During which month was consumer confidence the highest? The lowest?
2. Describe the changes in consumer confidence from August through December.
3. The devastation caused by Hurricane Katrina and resulting increase in gasoline prices led to the abrupt drop in consumer confidence shown in the graph. What other events might cause a decline in consumer confidence?

# SECTION 2 Assessment

## REVIEWING KEY CONCEPTS

1. Why is the U.S. economy sometimes referred to as a modified free enterprise system?
2. How does the profit motive work to allocate resources?
3. How do households and business firms interact in the product and resource markets?
4. Describe how the government interacts with the product and resource markets.
5. Study the circular flow models on pages 53 and 80. How are the two models different?

**6. Using Your Notes** Explain how producers, consumers, and the government interact to allocate resources in a free enterprise system.



Use the Graphic Organizer at **Interactive Review @ ClassZone.com**

## CRITICAL THINKING

**7. Applying Economic Concepts** Think of several examples in which consumers have voted with their dollars and driven a product from the market or into high demand. Record your ideas in a table like the one below.

Consumers Drive Product from the Market	Consumers Drive Product into High Demand

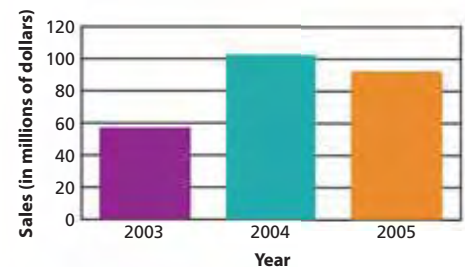
8. **Comparing and Contrasting Economic Information** Compare and contrast the role of consumers and producers in allocating resources. Which do you think has the greater power?
9. **Interpreting Economic Models** Use the circular flow chart on page 80 and what you have learned from this section to explain the ways in which government allocates resources.
10. **Challenge** What industries in today's world do you think would be wise to make changes given consumers' preferences? Give reasons for your selections.

## ECONOMICS IN PRACTICE



### Analyzing Economic Information

Look at the graph below, which shows the sales figures for a company that makes a substance that reduces carbohydrates in baked goods.



**Interpret Information** Write a sentence or two explaining the trend that the graph shows.

**Challenge** If you were the head of the company that made the substance that reduces carbohydrates in baked goods, in what direction would you move your business? How might you reallocate your resources?

# Government and Free Enterprise

## OBJECTIVES

- In Section 3, you will
- understand that one role of government in the U.S. economy is to address market failures
  - analyze why governments provide public goods and infrastructure
  - explain how governments seek to decrease negative externalities and increase positive externalities

## KEY TERMS

market failure, p. 84  
 public goods, p. 84  
 free rider, p. 85  
 infrastructure, p. 86  
 externality, p. 87  
 negative externality, p. 87  
 positive externality, p. 87  
 subsidy, p. 88  
 safety net, p. 89  
 transfer payment, p. 89  
 public transfer payment, p. 89

## TAKING NOTES

As you read Section 3, complete a cluster diagram to show the role of government in free enterprise. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



## Providing Public Goods

### KEY CONCEPTS

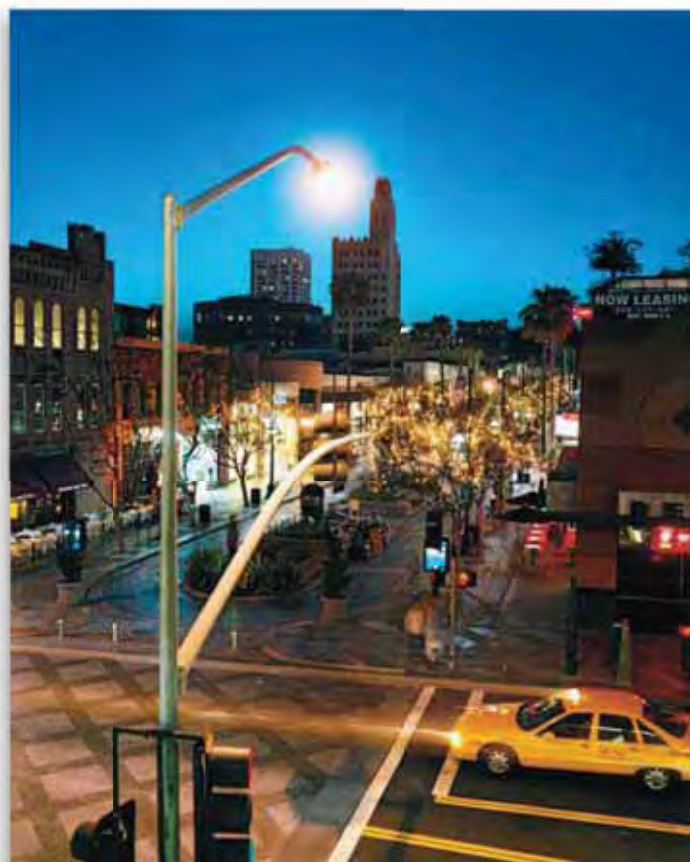
In the American economic system, most production decisions are made in the marketplace through the interactions of buyers and sellers. This is the free enterprise sector of our economy. Other decisions are made by different levels of government. This is the public sector of our economy. How do we decide which sector of the economy should produce a good or service? If all the costs are borne by, and all benefits go to, the buyer and seller, the free enterprise sector produces it. If people who are not part of a marketplace interaction benefit from it or pay part of the costs, there is a **market failure**. When market failures occur, the government sometimes provides the good or service. Goods and services that are provided by the government and consumed by the public as a group are **public goods**. Public goods are funded with taxes collected by the government.

### QUICK REFERENCE

**Market failure** occurs when people who are not part of a marketplace interaction benefit from it or pay part of its costs.

**Public goods** are products provided by federal, state, and local governments and consumed by the public as a group.

**Public Goods** A city street lighting system is an example of a public good.





## EXAMPLE Characteristics of Public Goods

Public goods have two characteristics. First, people cannot be excluded from the benefits of the product even though they do not pay for it. Second, one person's use of the product does not reduce its usefulness to others.

Perhaps the simplest example of a public good is street lighting. When the street lighting is on, it is impossible to exclude people from using it. In addition, the benefit you receive from the safety and security street lighting provides is not diminished because others receive it too. There is simply no way for a private business to establish a realistic price for street lighting and then collect it from all users. Rather, local governments provide street lighting, paying for it with taxes.

Another example of a public good is national defense. Everyone benefits from the country being defended. Further, the security you feel knowing that there is a national defense system in place is not diminished because other people feel secure too. Given these benefits, you would readily pay for this sense of security. However, what if you discovered that your neighbors were not paying for national defense? Would you voluntarily pay then? To avoid this problem, everyone is required to pay taxes to the national government, which provides national defense.

## EXAMPLE Free Riders

There is no incentive for businesses to produce public goods, because people will not voluntarily pay for them. After all, people receive the benefits of these products whether they pay for them or not. This situation is called the free-rider problem, and it is one type of market failure. A **free rider** is a person who chooses not to pay for a good or service but who benefits from it when it is provided.

Consider a July 4th fireworks display, which can cost \$200,000 or more. If you tried to set up a business to put on such displays, you'd immediately run into problems. There is no way to charge people for watching the display, since it is visible from so many locations. Even if you were able to charge a fee to watch from a particularly good location, many people would still be able to watch it from elsewhere without paying. Those people are free riders—they receive the thrill and enjoyment of the fireworks display, but they do not share in the costs of putting it on. Because of them, there is little interest in providing fireworks displays as a business opportunity.

One way to address the free-rider problem is for government to provide certain goods and services. The city government, for example, could put on the July 4th fireworks display, using taxes to pay for it. In this way, the costs and benefits are shared throughout the community.

### QUICK REFERENCE

A **free rider** is a person who avoids paying for a good or service but who benefits from that good or service anyway.



**Free Riders** Free riders will choose not to pay for fireworks displays but will still enjoy the benefits. Because of this, private companies are reluctant to provide such services.

Another example of the free-rider problem is law enforcement. Once a policing system is established, everyone in the community is protected whether they pay for it or not. The best way to ensure that people who benefit from this protection pay a share of the costs is for government to provide the service, paying for it with taxes.

### Public and Private Sectors—Shared Responsibilities

Some goods can be provided by either the public sector or the private sector. These often are toll goods—goods consumed by the public as a group, but people can be excluded from using them. For example, toll ways are open for all people to use, but those who do use them have to pay a toll. Similarly, parks are provided for the benefit of everyone, but those who want to enjoy this benefit may have to pay an entrance fee. The initial funding for toll goods is often provided by the public sector. Their day-to-day operation is often the responsibility of the private sector.

The private and public sectors share the responsibility for the nation's **infrastructure**, the goods and services that are necessary for the smooth functioning of society, such as highways; mass transit; power, water, and sewer systems; education and health care systems; and police and fire protection. How important is the infrastructure? Imagine, for example, what the United States would be like without its interstate highways, safe airports and seaports, and passenger and freight train systems. To begin with, the nation's economy would grind to a halt. Further, the nation would lose its ability to move troops in case of attack or to evacuate people in an emergency. A solid infrastructure, then, is essential to economic health.

#### QUICK REFERENCE

The **infrastructure** consists of all the goods and services that are necessary for the functioning of society.

### YOUR ECONOMIC CHOICES

#### PUBLIC vs. PRIVATE

#### Will you support tax increases to improve recreational facilities?

The mayor wants to build a water park to attract visitors, who will spend money at your town's restaurants and stores. But what you pay in sales tax will rise by about \$100 a year to cover the cost. With that money, you could buy a couple of video games. What will you choose—public wants or private wants?



Water park



Video game

### APPLICATION Applying Economic Concepts

- A. Identify another example in which the free rider problem makes public goods or services the best solution.

# Managing Externalities

## KEY CONCEPTS

Another type of market failure occurs when economic transactions cause externalities. An **externality** is a side effect of a transaction that affects someone other than the producer or the buyer. A **negative externality** is an externality that is a negative effect, or cost, for people who were not involved in the original economic activity. For example, a manufacturing company discharges pollution into a nearby river. The costs of the pollution are borne by everyone who lives by the river, even if they have no connection to the manufacturing company. A **positive externality**, in contrast, is an externality that is a positive effect, or benefit, for people who were not involved in the original economic activity. Another of your neighbors, for example, plants and maintains a beautiful rose garden. All the surrounding homes benefit from the beauty.

## EXAMPLE Paying for Negative Externalities

One of the most commonly discussed negative externalities is industrial pollution. The owner of a factory that belches filthy smoke in the air, influenced by such

## QUICK REFERENCE

An **externality** is a side effect of a product that affects someone other than the producer or the buyer.

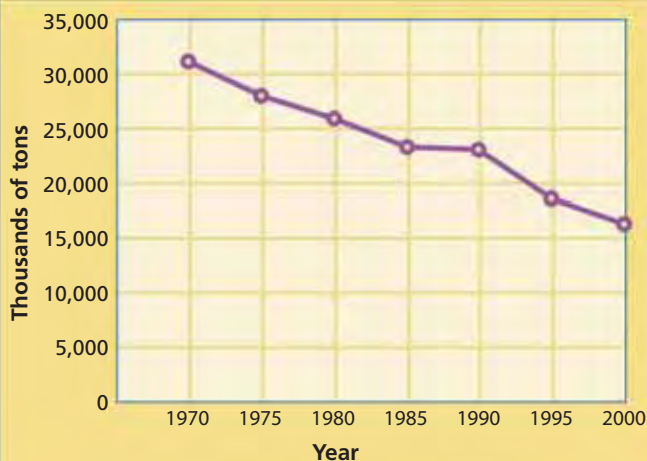
A **negative externality** is an externality that imposes costs on people who were not involved in the original economic activity.

A **positive externality** is an externality that creates benefits for people who were not involved in the original economic activity.

## Paying for Pollution

A 1990 amendment to the Clean Air Act set a limit on the amount of sulfur dioxide that industries could release into the air. The government distributed to those industries only enough "pollution permits" to meet that limit. Instead of using their permits, some companies used cleaner production methods and sold the permits to other companies. As the price of these permits rose, more and more companies developed production methods that did not pollute.

FIGURE 3.7 SULFUR DIOXIDE EMISSIONS



Source: Environmental Protection Agency



## ANALYZE GRAPHS

1. How would you describe the trend in sulfur-dioxide pollution, especially since changes in government policy in 1990?
2. How did the government take a market approach to the problem of pollution?

market forces as the profit motive and competition, has little incentive in the short-term to pay the extra money required to reduce the pollution. Everyone living in the surrounding region suffers from this pollution. Not only do they bear the monetary cost of cleaning up the pollution, they suffer other costs too. They are more likely to suffer pollution-related illnesses and, therefore, face higher medical costs.

Limiting negative externalities, then, is one important role of the government in the American economy. The government taxes or fines the polluter, and in the process accomplishes two economic purposes. The money it raises through taxation and fines can offset the higher medical costs. In addition, the cost of the tax or fine to the factory owner provides an incentive to reduce pollution.

### EXAMPLE Spreading Positive Externalities

Positive externalities are benefits that extend to people not involved in the original activity. For example, if a new college is built in your town, local businesses benefit from student purchases of goods and services. Workers benefit too, for as business expands to meet students' wants, more and more jobs become available. The community as a whole benefits from all the taxes collected from students. Local government is able to spend some of these funds to provide more public goods. In addition, the whole community benefits from the potential contribution a more skilled and knowledgeable population can make to the economy.



**Positive Externalities** The government will try to spread the benefit of a flu vaccination program—a healthier population—as widely as possible.

Just as government attempts to limit negative externalities, it tries to increase positive externalities. One way government does this is through subsidies. A **subsidy** is a government payment that helps cover the cost of an economic activity that is considered to be in the public interest. Since subsidies are paid for with taxes, everyone shares in their cost. Subsidies also spread the benefit of a positive externality as widely as possible. For example, the federal government might provide subsidies to drug companies to develop a new vaccine. This benefits the whole population in the long run because once the vaccine is in use there will be fewer and fewer infected people to spread the disease. Similarly, a local government might subsidize influenza shots for the community. Obviously, those people who take advantage of the free or inexpensive shots benefit because they are protected against infection. Even those people who don't get the shot still receive a benefit because they are less likely to encounter someone with the flu and therefore less likely to catch it themselves.

#### QUICK REFERENCE

A **subsidy** is a government payment that helps cover the cost of an economic activity that has the potential to benefit the public as a whole.

### APPLICATION Explaining an Economic Concept

B. How might a drunk-driving law address negative externalities?

# Public Transfer Payments

## KEY CONCEPTS

In addition to providing public goods and managing externalities, the government plays another role in the economy. One limitation of free enterprise is that people who are too old or sick to make a full economic contribution do not always have access to all economic opportunities. For these people, and others who are temporarily struggling, there is a public **safety net**, government programs designed to protect people from economic hardships.

## Redistributing Income

As many as 37 million people in the United States live below the poverty level, which was defined in 2005 as a yearly income of \$9,570 for a single person, with \$3,260 added for each additional household member. That is more than 12 percent of the nation's population. However, people move up and down the income ladder in the United States. Many poor families remain poor for a relatively brief time. For example, the median duration of poverty through the 1990s was between four and five months.

How does a modern society address economic issues such as poverty? One way is to encourage economic growth. Another is through **transfer payments**, transfers of income from one person or group to another even though the receiver does not provide any goods or services in return. Some transfer payments are between private individuals. When you receive cash and checks from relatives and friends for your birthday or graduation, you are receiving transfer payments. When someone dies, a transfer payment flows to his or her beneficiaries in the form of inheritance. In both cases, the receiver provides nothing in return for the payment.

A **public transfer payment** is a payment in which the government transfers income from taxpayers to recipients who do not provide anything in return. Public transfer payments, since they do not reflect exchanges within a marketplace, are not a characteristic of pure market economies. They are more characteristic of command economies, and their presence in the United States is one feature that makes the U.S. economy a mixed economy.

Most public transfer payments are in the area of social spending—spending designed to address social issues, such as poverty. Social Security benefits, for example, have significantly reduced poverty among the elderly. This program is funded by the contributions of people currently employed. They pay a social security tax to the federal government, which in turn transfers it to people who are at or past retirement age. The Social Security program also provides income for the disabled.

## QUICK REFERENCE

The **safety net** consists of government programs designed to protect people from economic hardship.

**Transfer payments** are transfers of income from one person or group to another even though the receiver does not provide anything in return.

A **public transfer payment** is a transfer payment in which the government transfers income from taxpayers to recipients who do not provide anything in return.

Public Transfer Payments	
Type	2004 Expenditures (in billions of dollars)
Social Security benefits	517.8
Medicare	303.3
Medicaid	299.7
Supplemental Security Income	37.3
Unemployment compensation	37.1
Veterans' benefits	33.8
Food Stamps	25.8
Temporary Assistance for Needy Families	18.5

Source: U.S. Department of Commerce



**Public Transfer Payments** Social Security is the largest public transfer program.

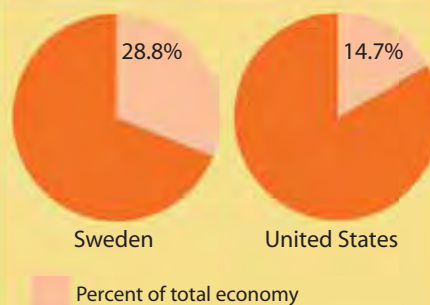
## A GLOBAL PERSPECTIVE

### Social Spending in Sweden

In market economies, all economic actors—including governments—have to make choices. One economic choice governments must make involves the level of funding for social spending. Sweden's government, for example, has chosen to spend a significant amount in this area. Close to 30 percent of the country's total economy is spent on such programs as free public education through college, national health, and retirement and disability pensions. In comparison, social spending in the United States is about 15 percent of the total economy. U.S. social programs are not as comprehensive as Sweden's.

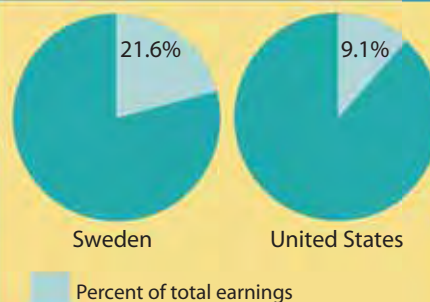
Such generosity, however, comes at a price. Sweden's workers pay hefty taxes to fund this social spending. Average Swedish workers with two children pay about 22 percent of their income in taxes. In contrast, similar American workers pay only about 9 percent.

FIGURE 3.8 SOCIAL SPENDING



Source: Organization for Economic Co-operation and Development, 2001 figures

FIGURE 3.9 HOUSEHOLD TAX BURDEN



Source: Organization for Economic Co-operation and Development, 2003 figures

#### CONNECTING ACROSS THE GLOBE

- 1. Synthesizing Economic Information** How do tax levels relate to the amount of resources devoted to social spending?
- 2. Drawing Conclusions** Which country do you think has more of a market economy, Sweden or the United States? Why?

The government makes transfer payments to the very poor as well as to the aged and disabled. For many years, the program known as welfare made payments to the needy to assure their well-being. A debate developed about whether such a program fostered dependence on the government and removed incentives to break out of poverty. In response to this debate, the government introduced sweeping reforms in the mid-1990s. The new program, widely known as workfare, stressed the importance of helping welfare recipients enter or re-enter the workforce as quickly as possible. Since these reforms in 1997, 4.7 million Americans have moved from being dependent on welfare to self-sufficiency.

Public transfer payments also provide a safety net for people who lose their jobs. Unemployment compensation from a mix of federal and state money tides people over until they can find a new job. While people receive it, they must show that they are making an effort to find another job. (You will learn more about unemployment, poverty, and government social spending in later chapters.)

#### APPLICATION Applying Economic Concepts

- C. What are the opportunity costs of public transfer payments?

# SECTION 3 Assessment

## REVIEWING KEY CONCEPTS

1. Explain the relationship between the terms in each of these pairs:
  - a. *market failure*  
*free rider*
  - b. *negative externality*  
*positive externality*
  - c. *subsidy*  
*positive externality*
  - d. *safety net*  
*public transfer payment*
2. Illustrate the two characteristics of public goods with examples.
3. How is infrastructure linked to the economy?
4. Give an example of a free rider.
5. How can government limit a negative externality? How can it spread a positive one?

- 6. Using Your Notes** Explain how the government gets involved in the economy in a modified free enterprise system. Refer to your completed cluster diagram.

Use the Graphic Organizer at  
**Interactive Review @ ClassZone.com**



## CRITICAL THINKING

7. **Categorizing Economic Information** Unemployment compensation and payment of living expenses for the disabled are examples of what kind of government involvement in the American economy?
8. **Making Inferences** After several incidents of hallway disputes among students, the board of a high school decides to hire hallway guards. In economic terms, what is the school board doing? How might this decision affect other programs at the school?
9. **Evaluating Economic Decisions** As part of the welfare reform of the mid-1990s, the federal government hired 10,000 people who had been dependent on welfare in an initiative called welfare-to-work. How does this approach differ from transfer payments? What are the costs and benefits of this approach?
10. **Challenge** In 2003, Congress passed laws to encourage private charitable organizations to provide social services. They would compete for government funds to carry out community services through their own networks. Do you think this is an effective way to address social issues? Why or why not? Use economic concepts, such as markets, efficiency, and opportunity costs in developing your response.

## ECONOMICS IN PRACTICE



Cleaning up a toxic dump

### Categorizing Economic Information

Externalities are categorized according to their impact, either positive or negative.

**Identify Externalities** Decide whether each of the following is a positive or a negative externality and briefly explain its effect.

- A beekeeper establishes a farm next to an apple orchard and the bees move freely into the orchard.
- An airport is constructed near a residential neighborhood.
- A construction company cleans up a toxic dump near a site it is working on.
- Companies pay for programs to help employees get in shape.

**Challenge** Identify and explain a negative externality and a positive externality that affect you.

# The United States: Land of Entrepreneurs

**Background** The free enterprise system and the belief that everyone has the right to pursue economic success through lawful means is the backbone of American society. Many people achieve that success through working for an employer who provides a place to work, a paycheck, and other benefits. However, an increasing number of people are working for themselves, and for a variety of reasons. These reasons include a desire to market their own products, or to have more freedom.

**What's the issue?** What are some of the options for opening your own business? Study these sources to learn how others found their way, and the obstacles and opportunities they faced.

## A. Magazine Article

This article discusses the development of Fizzy Lizzy, a new soft drink, from initial concept through launch, and introduces the entrepreneur who came up with the idea.

## A Business Idea in a Bottle

### Getting Fizzy Lizzy Bubbling

[Elizabeth] Marlin . . . got into the beverage business in the summer of 1996, when she set out for a long bicycle ride. . . . Not long into her trip, she realized that her favorite refreshment, which she had packed into a saddlebag—a half-gallon carton of grapefruit juice and a liter bottle of seltzer, which she'd mix together—was not only inconvenient, it was also slowing her down.

"Juice and seltzer is so simple," Marlin said. "I thought, Why can't I buy this in a bottle?" She . . . was fixated on the idea of creating a carbonated juice, and began researching the beverage industry. She soon discovered she would need to hire a food scientist to help her. . . .

Although Marlin planned to devote her entire checking account to startup costs, that amount was nowhere near what [Abe] Bakal (consultant with 30 years' experience) was asking for R & D alone. . . . [B]ut he was so impressed by her enthusiasm that he offered to consult in return for a 20-percent stake in the business. . . .

Bakal recalled recently, ". . . one of the things I've learned in product development is that sometimes—not always, but sometimes—you can compensate with enthusiasm and commitment for money."

Source: "The Industry: Message in a Bottle," *New York Times*, June 26, 2005



**Thinking Economically** How did Elizabeth Marlin and Abe Bakal use their productive resources to start this enterprise?



**FIGURE 3.10 BUSINESS ENTERPRISES BY EMPLOYMENT SIZE**

Number of Employees	Number of Firms	Total Employment
No employees	770,229	0
1–9 employees	3,759,630	12,500,539
10–99 employees	1,135,443	28,516,802
100–499 employees	84,829	16,430,229
500+ employees	16,926	55,950,473
All	5,767,127	113,398,043

Source: *Statistical Abstract of the United States*, 2003 figures

### B. Chart

These statistics show the number of self-employed entrepreneurs and their businesses relative to sizes of firms with paid employees.

**Thinking Economically** What is the percentage of entrepreneurial firms with no employees? What percentage of paid employees work in companies with 100 or more workers?

### C. Newspaper Article

This article discusses franchises, businesses that offer entrepreneurs an option to start their own business by buying into an established company with an existing business model.

## Being The Boss With Backup

### The Costs and Benefits of Franchising

In Maryland, there were more than 13,000 franchises employing about 179,000 [people] in 2001, according to [a] study, which was commissioned by the International Franchise Association. More than two dozen of those franchises are headquartered in the state, including Educate Inc., with more than 1,000 Sylvan tutoring center franchises worldwide and MaggieMoos's International with 184 ice cream shops, according to the association.

Opening such a business might be just the right fit for Phil Clark, a mortgage consultant from Elkridge. The mortgage business tends to fluctuate, Clark said. A franchise would give Clark more control over his future, a prospect he finds exciting. "A franchise gives me something more stable," he said. . . .

But it comes at a price. The cost of opening a franchise can vary from \$25,000 to millions of dollars.

For some, franchising can mean economic empowerment and a chance at the American dream. But buyer beware: There is no guarantee of success, and a franchise requires the same amount of commitment, sacrifice and sweat equity as any independent business. . . .

Source: "Growing Occupation: Being Your Own Boss," *Baltimore Sun*, April 21, 2006

**Thinking Economically** If you were to start your own business, would you buy a franchise or build a new enterprise based on your own ideas? What factors would help you in making your decision?

### THINKING ECONOMICALLY Synthesizing

1. How do the legal rights built into the free enterprise system affect the businesses in A and C?
2. Which of these two businesses do you feel would provide more stability for its owner? Why?
3. Do you think entrepreneurs make up a large percentage of the work force? Why are entrepreneurs important to the economy?

Review this chapter using interactive activities at **ClassZone.com**

- Online Summary
- Quizzes
- Vocabulary Flip Cards
- Graphic Organizers
- Review and Study Notes

## Online Summary

Complete the following activity either on your own paper or online at **ClassZone.com**

**Choose the key concept that best completes the sentence. Not all key concepts will be used.**

<a href="#">capitalism</a> <a href="#">externality</a> <a href="#">free contract</a> <a href="#">free enterprise system</a> <a href="#">infrastructure</a> <a href="#">legal equality</a>	<a href="#">modified free enterprise economy</a> <a href="#">negative externality</a> <a href="#">open opportunity</a> <a href="#">positive externality</a> <a href="#">profit</a> <a href="#">profit motive</a>	<a href="#">public goods</a> <a href="#">public transfer payments</a> <a href="#">safety net</a> <a href="#">subsidy</a> <a href="#">transfer payments</a>
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1 is another name for capitalism. Three features of this type of economy are open opportunity, legal equality, and 2, or the right to enter into agreements of one's choice. The 3 is a driving force in a free enterprise system, urging entrepreneurs to enter the market. The market allocates resources through the activities of both producers and consumers. Producers, seeking 4, move their resources into the most productive areas. Consumers, through their dollar votes, help determine which products succeed and which fail.

Left on its own, however, a free market cannot address many social issues. The United States has a 5, mixing government involvement and market forces. One role for the government is to provide 6, such as national defense. Without a strong 7 in place, modern economies cannot function. The government also addresses problems created by a 8, such as the pollution from a factory that affects all those living nearby. It furthers a 9, such as better health through vaccinations, by offering a 10 for inoculations. The government also makes direct 11 in the form of social security, unemployment compensation, and disability coverage.

### REVIEWING KEY CONCEPTS

#### Advantages of the Free Enterprise System (pp. 70–77)

1. What is a free enterprise system?
2. What are some of the rights that must be protected for a free enterprise system to work?

#### How Does Free Enterprise Allocate Resources? (pp. 78–83)

3. What are the roles of consumers and producers in allocating resources?
4. What role does the government play in the economy's circular flow?

#### Government and Free Enterprise (pp. 84–93)

5. What problem makes public goods necessary?
6. Besides providing public goods, what two purposes can a government serve in a market economy?

### APPLYING ECONOMIC CONCEPTS

Use the information in the table to answer the following questions about changes in the nation since the passage of the Clean Air Act in 1970.

Since the passage of the Clean Air Act:
<ul style="list-style-type: none"> <li>Nitrogen oxide emissions have declined by 17%</li> <li>Sulfur dioxide emissions have declined by 49%</li> <li>Lead emissions have declined by 98%</li> <li>Carbon monoxide emissions have declined by 41%</li> <li>Particulate emissions caused by combustion have declined by 82%</li> </ul>
At the same time:
<ul style="list-style-type: none"> <li>U.S. population grew by 42%</li> <li>Overall energy consumption grew by 43%</li> <li>Total U.S. employment grew by 95%</li> <li>The number of registered vehicles grew by 111%</li> <li>The economy grew by 175%</li> </ul>

Source: Foundation for Clean Air Progress

7. How would you use these statistics to argue that the government has effectively managed a negative externality?
8. Recently, there has been pressure to loosen clean air standards. Use economic arguments to support or oppose this proposed action.

## CRITICAL THINKING

**9. Creating Graphs** Use the statistics below to create a graph titled *Businesses in the United States, 1997–2003*. Use information from your graph and from Figure 3.1 on page 71 to write a generalization about businesses in the American free enterprise system.

Year	Number of Businesses (in millions)
1997	21.0
1999	21.8
2001	22.6
2003	22.7

Source: U.S. Small Business Administration

Use  **SMARTGrapher** @ **ClassZone.com** to complete this activity.

**10. Distinguishing Fact from Opinion** Look again at the information on changes in the United States after the passage of the Clean Air Act. Which of the following statements represents a fact? Which is an opinion? Explain why.

- Pollution has decreased since 1970.
- Pollution has decreased as a result of the Clean Air Act.
- The government can ease restrictions now that pollution is lower.

**11. Applying Economic Concepts** In the 1990s, efforts were made to reform the healthcare system in the United States so that much of it came under government control. Explain in terms of economic concepts you have learned in this chapter why these efforts failed.

**12. Challenge** Milton Friedman wrote,

*Many people want the government to protect the consumer. A much more urgent problem is to protect the consumer from the government.*

Explain what you think Friedman meant by this. Illustrate your answer with examples.

## SIMULATION



### Conducting an Economic Impact Study

A manufacturing company has announced plans to open a factory in your town. The plant will consist of a manufacturing area and a warehouse area and will employ about 500 people. Production will be on a 24-hour basis, with workers working one of three 8-hour shifts. At the same time, a national megastore chain wants to open a store on the outskirts of town. The store will employ 60 people, be open 18 hours a day, and have a 200-car parking lot.

Imagine that you have been asked by local government authorities to conduct an economic impact study to identify the positive and negative externalities that the factory or megastore might create.

**Step 1** Form a group with three or four classmates. Conduct research on how a factory or a megastore operates—the materials they use, the byproducts they create, and so on. Then do research to discover the impact a new factory or megastore might have on a community.

**Step 2** In your group, review your findings and identify the positive and negative externalities of the factory or megastore. Record the information in a chart similar to the one below.

Externalities Created by the Factory/Megastore	
Positive	Negative

**Step 3** Use your chart to write your economic impact report. Note the major externalities and suggest steps that the local government might take to limit negative externalities and to encourage positive externalities.