



CHAPTER 2

How Economic Issues Affect Business

BRIEF CHAPTER OUTLINE AND LEARNING GOALS

Opening Profile: Getting To Know: Matt Flannery

I. HOW ECONOMIC CONDITIONS AFFECT BUSINESS

➤ **Learning Objective 1**

Describe basic economics.

- A. What is Economics?
- B. The Secret to Creating a Wealthy Economy
- C. Growth Economics and Adam Smith
- D. How Businesses Benefit the Community

➤ **Learning Objective 2**

Explain what capitalism is and how free markets work.

II. UNDERSTANDING FREE-MARKET CAPITALISM

- A. How Free Markets Work
- B. How Prices Are Determined
- C. The Economic Concept of Supply

- D. The Economic Concept of Demand
- E. The Equilibrium Point and the Market Price
- F. Competition Within Free Markets
- G. Benefits and Limitations of Free Markets

➤ **Learning Objective 3**

Compare the benefits and negative consequences of socialism and communism.

III. UNDERSTANDING SOCIALISM

- A. The Benefits of Socialism
- B. The Negative Consequences of Socialism

IV. UNDERSTANDING COMMUNISM

V. THE TREND TOWARD MIXED ECONOMIES

➤ **Learning Objective 4**

Describe the mixed economy of Canada.

VI. CANADA'S MIXED ECONOMY

➤ **Learning Objective 5**

Illustrate the significance of key economic indicators and the business cycle.

VII. UNDERSTANDING CANADA'S ECONOMIC SYSTEM

- A. Key Economic Indicators
 - 1. Gross Domestic Product
 - 2. Productivity in Canada
 - 3. Productivity in the Services-Producing Sector
 - 4. The Unemployment Rate
 - 5. The Price Indexes
- B. The Business Cycle

Key Terms

brain drain
business cycles
(economic cycles)

capitalism
command economy
communism

consumer price index
(CPI)
deflation

demand	inflation	perfect competition
depression	invisible hand	recession
disinflation	macroeconomics	resource development
economics	market price	socialism
free-market economy	microeconomics	stagflation
gross domestic product (GDP)	mixed economies	supply
human development index	monopolistic competition	unemployment rate
	monopoly	
	oligopoly	

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Standard of Living Comparison

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Foundations Of The Capitalist System

Lecture Outline	
Outline	Supplements
The PROFILE at the beginning of the chapter focuses on Matt Flannery, the CEO of microlender Kiva.org. Operating much like crowdfunding sites, the company relies on many small donation to fund entrepreneurs in the developing world. Flannery built the organization after he worked in rural communities in Africa, and notes the impact of small businesses on their communities. Today, Kiva has lent more than \$500 million to entrepreneurs throughout the world.	
I. HOW ECONOMIC CONDITIONS AFFECT BUSINESS To understand the SITUATION AND CONDITIONS that INFLUENCE Canadian BUSINESS you must: 1. have some grasp of ECONOMICS 2. be aware of the impact of the GLOBAL ENVIRONMENT 3. understand the ROLE OF GOVERNMENTS in Canada A major part of business success is due to an economic and social climate that allows businesses to operate freely. Any change in our economic or political system can have a major influence on business. ➤ Learning Objective 1 <i>Describe basic economics</i> A. What is Economics? Economics is the study of how society chooses to employ resources to produce goods and services and distribute them for consumption among various competing groups and individuals. Businesses may contribute to an economic system by inventing products that greatly increase available resources. Macroeconomics is the part of economic study that looks at the operation of a nation's economy as a whole. Microeconomics is the part of economic study that looks at the behaviour of people and organizations in particular markets. Some economists define economics as the allocation of "scarce" resources. They believe that resources are scarce and that they	Lecture Link 2-1

need to be carefully divided among people, usually by the government. Resource development is the study of how to increase resources and the creation of the conditions that will make better use of those resources (e.g. recycling). Outside of government, businesses may contribute to an economic system by inventing products that greatly increase available resources such as discovering new energy sources (e.g. hydrogen), new ways of growing food, and new ways of creating needed goods and services. B. The Secret to Creating a Wealthy Economy The challenge for macroeconomists is to determine what makes some countries relatively wealthy and other countries relatively poor, and then to implement policies and programs that lead to increased prosperity for everyone in all countries C. Growth Economics and Adam Smith Adam Smith first defined capitalism in 1776. Rather than believing that fixed resources had to be divided among competing groups and individuals, Smith envisioned creating more resources so that everyone could become wealthier. He believed that freedom was vital to the survival of any economy, especially the freedom to own land or property and the freedom to keep profits from working the land or owning a business. D. How Businesses Benefit the Community Like an INVISIBLE HAND, the ECONOMY PROSPERS AND JOBS ARE CREATED as individuals, OWNING the means of production PRIVATELY, seek to make PROFIT from producing greater flows of goods for all. This also led to many INEQUALITIES and a search for SOLUTIONS. Invisible Hand is a phrase coined by Adam Smith to describe the process that turns self-directed gain into social and economic benefits for all. Smith assumed that as people became wealthier, they would naturally reach out to help the less fortunate in the community.	Seeking Sustainability Making Ethical Decisions
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➤ **Learning Objective 2**

Explain what capitalism is and how free markets

work.

II. UNDERSTANDING FREE-MARKET CAPITALISM

Following the ideas of Adam Smith, business people created more wealth than ever before.

GREAT DISPARITIES in wealth remained or even increased.

Although it is not easy, opportunities to start one's own business have always been there, especially in a free market.

Capitalism is an economic system in which all or most of the factors of production and distribution are privately owned and operated for profit.

In capitalist countries, business people decide what to produce, how much to pay workers, how much to charge for goods and services, where to sell these goods and services, and so on.

No country is purely capitalist but capitalism is the foundation for the economics of Canada, England, the United States, and most other developed nations.

A. How Free Markets Work

In a free-market system, decisions about what to produce and in what quantities are made by THE MARKET. That is, buyers and sellers negotiating prices for goods and services.

Consumers send signals to producers about what to make, how many, and so on through the mechanism of PRICE.

B. How Prices Are Determined

In a free market, prices are determined by buyers and sellers negotiating in the MARKETPLACE.

C. The Economic Concept of Supply

SUPPLEMENTAL
CASE 2-1

Spotlight on Small
Business

Supply refers to the quantity of products that manufacturers or owners are willing to sell at different prices at a specific time.

The amount supplied will increase as the price increases.

The SUPPLY CURVE indicates the relationship between the price and the quantity supplied. All things being equal, the higher the price, the more the vendor will be willing to supply.

Fig. 2.1

D. The Economic Concept of Demand

Demand refers to the quantity of products that people are willing to buy at different prices at a specific time.

Fig. 2.2

The quantity demanded will decrease as the price increases. The quantities consumers are willing to buy at certain prices are illustrated on a DEMAND CURVE.

Fig. 2.3

E. The Equilibrium Point or Market Price

The key factor in determining the quantity supplied and the quantity demanded is PRICE.

At the equilibrium price, the SUPPLY AND DEMAND CURVE cross, and the quantity demanded equals the quantity supplied.

Market price is the price determined by supply and demand.

In free-market economies, it is the INTERACTION between SUPPLY and DEMAND that determines the market price in the long-run.

Critical Thinking 2-1

If surpluses develop a signal is sent to sellers to lower the price. If shortages develop, a signal is sent to sellers to increase the price. Eventually it will even out the market again, if nothing interferes.

In countries without a free-market system, there are often shortages or surpluses. The government in these countries decides what the produce and in what quantity, but has no way of knowing what the proper quantities are.

One benefit of the free-market system is that it allows competition

among companies.

F. Competition within Free Markets

There are four different degrees of competition.

1. **Perfect competition** is the market situation in which there are many sellers in a market and no seller is large enough to dictate the price of a product.

Sellers produce products that appear to be identical.

2. **Monopolistic competition** is the market situation in which a large number of sellers produce products that are very similar but that are perceived by buyers as different.

PRODUCT DIFFERENTIATION, making buyers think similar products are different, is a key to success.

3. An **oligopoly** is a form of competition in which just a few sellers dominate a market.

The INITIAL INVESTMENT required to enter the market is usually high and prices among competing firms tend to be close to the same.

Intense price competition would lower profits for all competitors, since a price cut on the part of one producer would most likely be matched by the others.

4. A **monopoly** occurs when there is only one seller for a good or service.

There are few examples of a monopoly in Canada.

G. Benefits and Limitations of Free Markets

Free-market capitalism provides OPPORTUNITIES for poor people to work their way out of poverty.

Businesses must provide customers with quality products at fair prices with good service; otherwise they will lose customers to their competitors who do this.

Fig. 2.4

Smith assumed that as people became wealthier, they would naturally reach out and help the less fortunate in the community. This has not always happened, but business people are becoming more concerned about social issues and their obligation to return to society some of what they've earned.

Business people may let greed dictate how they act, as seen in recent scandals in accounting firms, telecommunications firms, and others.

SOME government regulations are NECESSARY to protect stakeholders and vulnerable citizens.

➤ **Learning Objective 3**

Compare the benefits and negative consequences of socialism and communism.

III. UNDERSTANDING SOCIALISM

Socialism is an economic system based on the premise that some, if not most, basic businesses should be owned by the government so that profits can be evenly distributed among the people.

Small businesses are owned by entrepreneurs, but their profits are steeply taxed to pay for social programs. Some tax rates are as high as 60 percent.

A. The Benefits of Socialism

Advocates of socialism acknowledge the major benefits of capitalism but they believe that WEALTH should be more evenly distributed.

B. The Negative Consequences of Socialism

Socialist nations rely heavily on GOVERNMENT to provide education, health care, retirement benefits, and other social services.

Socialism also results in fewer inventions and less innovation because those who come up with new ideas usually don't receive as much reward as they would in a capitalist system.

Neither of these systems has resulted in optimum economic conditions.

Free-market mechanisms haven't been responsive enough to a nation's social and economic needs.

Socialism and communism haven't always created enough jobs or wealth to keep economies growing fast enough.

The trend is for so-called capitalist countries and so-called socialist countries to move toward the centre.

Mixed economies are economic systems in which some allocation of resources is made by the market and some by the government.

- **Learning Objective 4**
Describe the mixed economy of Canada.

VI. CANADA'S MIXED ECONOMY

Canada's LARGE TERRITORY and SMALL POPULATION plus the INFLUENCE and POWER of the U.S. economy led our GOVERNMENTS to play a large role in REGULATING and PROTECTING our economy. This has been CHANGING toward a LESSER role for government.

- **Learning Objective 5**
Illustrate the significance of key economic indicators and the business cycle.

VII. UNDERSTANDING CANADA'S ECONOMIC SYSTEM

When the economy is strong business prospers and when it is weak business declines. It is important to UNDERSTAND some BASIC ECONOMIC TERMS.

A. Key Economic Indicators

The three major economic indicators of economic conditions are:

1. the gross domestic product (GDP);

2. the unemployment rate; and
3. the price indexes.

1. Gross Domestic Product

Gross domestic product (GDP) is the total value of goods and services produced in a country in a given year. Either a domestic company or a foreign-owned company may produce the goods and services included in the GDP as long as the companies are located within the country's boundaries.

If there GDP growth declines or slows, there are often many negative effects on business.

A major influence on the growth of GDP is how productive the workforce is – that is, how much output workers create with a given amount of input.

A strong economy usually leads to a high **standard of living**, which is the amount of goods and services people can buy with the money they have. This is different than quality of life.

Quality of life is the general well-being of a society in terms of political freedom, a clean natural environment, education, health care, safety, free time, and everything else that leads to satisfaction and joy.

2. Productivity in Canada

Productivity is measured by dividing the total output of goods and services of a given period by the total hours of labour required to provide them.

An increase in productivity is achieved by producing a GREATER quantity of a certain quality for a GIVEN amount of work hours OR producing the SAME quantity with FEWER work hours.

Labour cost measures the same equation in dollars. The dollar value of outputs is divided by the dollar value of the work hours to arrive at the labour cost per unit.

Anything that increases productivity or reduces labour costs makes a business, and country, more competitive because prices

can be lower. The higher productivity is, the lower the costs are in producing products and the lower prices can be.

3. Productivity in the Services-Producing Sector

Because Canada is service intensive, the productivity level has not been increasing as steadily as manufacturing has been increasing, as there has been a lack of new technology to assist the service sector in becoming more productive.

Fig 2.6

Fig 2.7

4. The Unemployment Rate

The **unemployment rate** is the percentage of the labour force that actively seeks work but is unable to find work at a given time.

Lecture Link 2-2

The four types of unemployment are: frictional, structural, cyclical, and seasonal.

The unemployment rate is a key indicator of the health of the economy and of society more generally. That is, when economic growth is strong, the unemployment rate tends to be low and a person who wants a job is likely to experience little trouble finding one. When the economy is stagnating or in recession, unemployment rates tend to be higher.

5. The Price Indexes

The price indexes help measure the health of the economy by measuring the levels of inflation, disinflation, deflation and stagflation.

Inflation refers to a general rise in the prices of goods and services over time.

Inflation increases the cost of doing business.

Disinflation describes a situation in which price increases are slowing (the inflation rate is declining).

Deflation is a situation in which prices are declining. It occurs when countries produce so many goods that people cannot afford to buy them all.

Stagflation occurs when the economy is slowing but prices are going up regardless.

The **consumer price index (CPI)** consists of monthly statistics that measure the pace of inflation or deflation.

Other indicators of the economy's condition include housing starts, retail sales, motor vehicle sales, consumer confidence, and changes in personal income.

Fig 2.8

B. The Business Cycle

Business cycles (also known as **economic cycles**) are the periodic rises and falls that occur in all economies over time.

Economist Joseph Schumpeter identified four key phases of long-term business cycles as boom, recession, depression, and recovery.

A boom is when the economy is doing very well, a **recession** is when two or more consecutive quarters of declining in the GDP occur, a **depression** is a severe recession, a recovery occurs when the economy stabilizes and starts to grow again.

The goal of economists is to predict such ups and downs. Business cycles are based on facts, but what those facts describe can be explained only by using theories.

TEXTBOOK CASE**ANALYZING MANAGEMENT DECISIONS QUESTIONS AND ANSWERS****THE RULE OF 72**

No formula is more useful for understanding inflation than the rule of 72. Basically, the rule allows you to quickly compute how long it takes the cost of goods and services to double at various compounded rates of growth. For example, if houses were increasing in cost at 9% a year, how long would it take for the price of a home to double? The answer is easy to calculate. Simply divide 72 by the annual increase (9%) and you get the approximate number of years it takes to double the price (eight years). Of course, the same calculation can be used to predict how high food prices or auto prices will be 10 years from now.

Here's an example of how you can use the rule of 72. If the cost of going to a post-secondary institution goes up by 6% a year, how much might you have to pay to send your child to a school in 24 years (this assumes you will have a child 6 years from now) if school costs are now \$10,000 a year? To find the answer, you divide 72 by 6, which shows that the cost of an education would double in 12 years. It would double twice in 24 years. Your son or daughter can expect to pay \$40,000 per year to attend a post-secondary institution.

VIDEO CASE**DISCUSSION QUESTIONS AND ANSWERS****THE BANK OF CANADA: COUNT ON US**

1. *The Bank of Canada has the mandate to contribute and enhance the well-being of Canadians. What three areas are targeted by the Bank of Canada as a way to do this?*

The Bank of Canada is called the banker's bank as it is the federal government's banker and financial advisor. Three areas targeted by the Bank of Canada include (1) keeping inflation low, stable and predictable; (2) ensuring that the financial system operates efficiently; and (3) to issue notes and preserve the value of money.

2. *How does the Bank of Canada try to keep the inflation in check?*

The Bank of Canada tries to keep the future rate of inflation close to 2 percent by influencing short-term interest rates. This is done by setting the target for the Overnight Rate, which influences commercial interest rates. The Overnight Rate is the interest rate charged and paid by major financial institutions when they borrow and lend money on a one day-to-day basis.

3. *What is the impact of high interest rates for consumers and businesses? How about low interest rates?*

If demand for goods and services is too strong, inflation will increase. When the Bank of Canada sees this, it can increase the Overnight Rate, which will then increase the cost of borrowing that is charged by financial institutions. Higher interest rates increase the cost of borrowing for both businesses and consumers oftentimes leading to a decreasing demand for goods and services.

When demand is weak, the Bank of Canada can encourage growth and demand by lowering the Overnight Rate. This results in lower commercial interest rates. Lower interest rates decrease the cost of borrowing and may be an incentive for firms to borrow in order to expand. Consumer may also increase their spending if the cost of borrowing decreases.

LECTURE LINK 2-1

EUROPE IS SHRINKING

At the end of the 20th century, massive changes took place in Europe—the Berlin Wall came down and communism disappeared as the Soviet Union collapsed. While the public's attention was focused on these historic events, another sea change was quietly taking place.

According to the United Nations, Europe's population will shrink by more than 90 million people in the next 50 years, roughly twice the number killed worldwide during World War II. For more than two decades the total fertility rate—the average number of children each woman will bear in her lifetime—has remained below the 2.1 level required to replace the population.

In the late 1990s Europe's population began to fall. Demographers doubt that the fertility rate will return to replacement level in the near future. Some speculate that the decline may not be limited to Europe. The world's population could actually decline by the end of the 21st century—a trend unseen since the 14th century Black Death.

Among the first nations to experience the population implosion will be historically fertile Italy. With births below replacement level since 1977, Italy is projected to lose nearly a quarter of its current population by 2050. Contraceptive use is at record levels, and women are earning more degrees than men, leading many to seek careers first and families second. Couples who do start families are waiting longer to have their first child.

Germany has one of the world's lowest birthrates: fewer babies were born in 2005 than in the last year of World War II. A United Nations report estimated that by 2050 Germany will need 3.5 million working-age immigrants each year to maintain its population ratio and fund pension, health care, and other programs.

Without babies to replenish the labour force and pay taxes, Europeans will find it hard to fund the pensions of longer living retirees. To stay in the black, governments will need to take unpopular steps, such as raising the retirement age, cutting benefits, hiking taxes, and increasing legal immigration.

Or do what France has done. Since World War I, France has been awarding medals to women "of good character" for bearing children. This is to encourage the restoration of its war-devastated population. Today, with France again in need of more children, France has relaxed its medal rules: the mothers don't have to be married; and they don't even have to be French.

Sources: Scott Elder, "Europe's Baby Bust," *National Geographic*, September 2003; "The Population Divide," *The Register-Guard*, 14 May 2006; and "Europe Facing Culture Dilemma," *The Clarion-Ledger*, 29 March 2006, 10A.

LECTURE LINK 2-2

OTHER ECONOMIC INDICATORS

In addition to the key economic indicators mentioned in the text—CPI, GDP, unemployment rate—there are other indicators measure different segments of the economy. Below are some of the more important ones.

KEY ECONOMIC INDICATORS

Producer Price Index	Monthly index that measures changes in wholesale prices
Prime Interest Rate	Lowest interest rate that banks charge preferred borrowers on short-term loans
Housing Starts	Tracks how many new single-family homes or buildings were constructed during the month and can detect trends in the economy looking forward.
Durable-Goods Orders	New orders for goods that last more than three years
Balance of Trade	Total value of a country's exports minus the total value of its imports, over a specific period of time
Inflation Rate	Percentage increase in prices of goods or services over a period of time.
Consumer Confidence Index	Measures the degree of consumer confidence in the economy, and can indicate an upcoming increase or decrease in economic activity.

TIMING OF THE INDICATORS

Economic indicators can further be classified by the timing of the indicator.

Some indicators are **lagging**, meaning that they don't change direction until a few quarters *after* the economy does. An example is the unemployment rate. Unemployment tends to increase for two or three quarters after the economy starts to improve.

Coincident indicators move *at the same time* as the economy does. The Gross Domestic Product measures the economy's output as it occurs.

Leading economic indicators are indicators which change *before* the economy changes. Stock market returns are a leading indicator, as the stock market usually begins to fall before the economy declines and they improve before the economy begins to pull out of a recession. Housing starts and the consumer confidence index are other leading economic indicators.

Sources: Mike Moffatt, "A Beginner's Guide to Economic Indicators," *About.com*, 16 May 2006; "Economic Indicators," *Investopedia.com*; "Leading Indicators Index Shows Economy Braking," *The Clarion-Ledger*, 19 May 2006, 3C; and "Economic Indicators," *GPOAccess*, Council of Economic Advisors, www.gpoaccess.gov.

Name _____

Date _____

CRITICAL THINKING EXERCISE 2-1**FINDING THE EQUILIBRIUM POINT**

In 2013, Sentra Electronics sold 350,000 digital video recorders (DVRs.) Based on the company's analysis of the DVR market, the company believed that \$160 was the equilibrium price based on the following supply and demand schedules.

Price (2013)	Amount Supplied	Amount Demanded
\$120	290,000	390,000
\$140	320,000	370,000
\$160	350,000	350,000
\$180	380,000	330,000
\$200	410,000	310,000
\$220	440,000	290,000

As the North American economy continued to be weak, consumers began going out less frequently for entertainment. With more people staying at home, DVR usage increased. In 2014, Sentra revised its estimate of the amount of product demanded. At each of the above price points, it was estimated that consumers would purchase (demand) 50,000 more DVRs. For instance, at \$140: 420,000 DVRs would be sold. The price/amount supplied relationship remains the same.

1. Describe what has happened to the supply and demand curves for Sentra DVRs in 2014.
2. What is the new equilibrium price?
3. How many DVRs will be produced at the new equilibrium price?
4. Sentra revised its estimate of the amount of product demanded for 2014 as described above. In 2015 a new technology became available enabling DVRs to communicate over cell phones and the Internet. Sentra's competitors are selling this new DVR, called SuperDVR, for \$150. What will happen to the supply and demand curves for Sentra DVRs now?

ANSWERS TO CRITICAL THINKING EXERCISE 2-1

1. *Describe what has happened to the supply and demand curves for Sentra DVRs in 2014.*

Supply remained unchanged. Demand shifted right, showing the increased quantity demanded at every price.

2. *What is the new equilibrium price?*

The quantity demanded and quantity supplied are now identical at \$180, which is a higher price. At that price, the quantity supplied remains stable at 380,000. However, the quantity demanded at that price is increased by 50,000 to 380,000. The equilibrium price will now be \$180.

Price (2009)	Amount Supplied	Amount Demanded
\$120	290,000	440,000
\$140	320,000	420,000
\$160	350,000	400,000
\$180	380,000	380,000
\$200	410,000	360,000
\$220	440,000	350,000

3. *How many DVRs will be produced at the new equilibrium price?*

At \$180, 380,000 DVRs will be produced.

4. *Sentra revised its estimate of the amount of product demanded for 2014 as described above. In 2015 a new technology become available enabling DVRs to communicate over cell phones and the Internet. Sentra's competitors are selling this new DVR, called SuperDVR, for \$150. What will happen to the supply and demand curves for Sentra DVRs now?*

With a more advanced DVR available from competitors, demand for Sentra DVRs will decrease at the same price. The demand curve shifts to the left, and the equilibrium price falls.

Name _____

Date _____

CRITICAL THINKING EXERCISE 2-2**STANDARD OF LIVING COMPARISON**

Is the standard of living different in capitalist, socialist, and communist economies? Which economic system provides the highest standard of living? One way of answering these questions is by comparing economic data you might find in the library or on the Internet. (Hint: try the CIA website.) Choose one capitalist country, one socialist country, and one communist country. Use the following chart to record your findings.

	CAPITALIST COUNTRY	SOCIALIST COUNTRY	COMMUNIST COUNTRY
Country Chosen			
Gross Domestic Product			
Consumer Prices			
Unemployment Rate			
Average Income			
Average Education			

ANSWERS TO CRITIAL THINKING EXERCISE 2-2

In searching for the answers to this exercise, students should go to the library or go online to find possible sources. One source is The World Factbook (<https://www.cia.gov/library/publications/the-world-factbook/>) which gives a surprisingly complete collection of economic and demographic data. As students search these sources, they can record the latest information they find. Even if they cannot find the answers, encourage them to note what information is available in those sources so they can refer to them again in the future.

Consumer prices are meaningless in an economy with of in most consumer goods. The official price and the price paid to unofficial sellers working underground are two radically different things. One lesson from an exercise like this is that information is often difficult to obtain from a controlled government and the information you do get may not be accurate.

SUPPLEMENTAL CASE 2-1**FOUNDATIONS OF THE CAPITALIST SYSTEM**

Throughout history of capitalism, there has been one persistent criticism. The whole system seems to be based on selfishness—the more one works, the more one prospers. If one is unable to work, the system seems to have no answer to his or her problems. Furthermore, there does not seem to be any moral or spiritual foundation to the system. Where do businesses get their values? What about concepts such as sharing, helping neighbors, and protecting the environment?

It is important to make a distinction between plain capitalism and democratic capitalism. Democratic capitalism is a system based on three components: (1) free enterprise; that is, freedom to own your own businesses and farms and freedom to keep the profits, (2) a freely elected government that has internal checks and balances, and (3) moral, ethical, and spiritual values that are part of the very fabric of the country and the business system. Plain capitalism is a system where there is free enterprise, but no freely elected government and no foundation of moral, ethical, and spiritual values. There are several “capitalist” countries headed by right-wing dictators that do not have democratic capitalism and do not have the relative prosperity and social justice that we have in the United States.

Let's explore democratic capitalism in more detail so that you can understand how the system works. One of the most important elements of democratic capitalism is its moral and spiritual base. When the U.S. was being settled, there was so much religious debate and rivalry among religions that people were tortured and killed for their beliefs. When it came time to establish a free and separate U. S., however, the founding fathers were adamant about freedom of religion. They were very religious people themselves.

Thomas Jefferson was proud of his religious heritage and his fight for religious freedom in the U.S. He asked that his epitaph should read: “Author of the Declaration of Independence, of the Statute of Virginia for Religious Freedom, and Father of the University of Virginia.” Jefferson felt that freedom of religion was one of his most important contributions. He felt it was as important as being President of the United States.

Democratic capitalism cannot work effectively and fairly without all three components. With all three, the democratic capitalist system can become the most fair and equitable economic system in the world. Not everyone agrees on the role of government in the democratic system and on how much of the total gross national product the government should control. (Recent history indicates that somewhere between 20% and 25% of GDP gives the government the funds it needs to create more social justice and more equitable distribution of wealth.) A freely elected government is important to democratic capitalism because if the people feel that the system is not fair, they can elect new politicians to change the rules.

Discussion Questions and Answers for Supplemental Case 2-1

1. Do you see any evidence that the moral, ethical, and spiritual foundation of the American democratic capitalist system is eroding? How does that affect the ability of capitalist proponents to promote capitalism in other countries such as China and India?
2. Why is it so necessary to have a freely elected government for democratic capitalism to create a prosperous and fair economy?
3. Go through the three components of democratic capitalism and picture an economy without each one. What happens to freedom, fairness, and moral and ethical behavior? Which part of the system seems weakest today? What can be done about it?

Notes on discussion questions for Supplemental Case 2-1

1. *Do you see any evidence that the moral, ethical, and spiritual foundation of the American democratic capitalist system is eroding? How does that affect the ability of capitalist proponents to promote capitalism in other countries such as China and India?*

When one of the authors was in elementary school, the codes of what was moral forbid him to see “The Moon Is Blue” because the movie used the word “virgin” in it. Now movies include more adult language and more violence and sexual content. In fact, many such movies are now available in prime time on TV. There does seem to be an erosion of moral and ethical behavior in business, witness the, Enron, WorldCom, and Lehman Brothers, and Conrad Black scandals. It could be a function of more media reporting of such behavior, but the impression is clear—moral decay is spreading.

When other countries see moral decay in capitalist countries, they are hesitant to adopt capitalism. They do not want the immorality, the crime, and the music that they see as corrupting of the spiritual values of their countries.

2. *Why is it so necessary to have a freely elected government for democratic capitalism to create a prosperous and fair economy?*

Because any kind of dictatorship hinders the operation of free markets, or at least tends to do so. Free choice in the market is based on a value system that includes free choice in it, including free choice of leaders.

3. *Go through the three components of democratic capitalism and picture an economy without each one. What happens to freedom, fairness, and moral and ethical behavior? Which part of the system seems weakest today? What can be done about it?*

Without free enterprise, shortages develop and the whole economy tends to slow. Poverty, hunger and starvation often result. Without a freely-elected government, the arbitrary allocation of resources can lead to the same problems as an absence of free markets. But what is needed in any economy is a moral and ethical base. Without that base, the market mechanism falters.