2

THE ECONOMY: MYTH AND REALITY

E pluribus unum (Out of many, one)

MOTTO ON U.S. CURRENCY

This chapter introduces you to the U.S. economy and its role in the world. It may seem that no such introduction is necessary, for you have probably lived your entire life in the United States. Every time you work at a summer or part-time job, pay your college bills, or buy a slice of pizza, you not only participate in the American economy—you also observe something about it.

But the casual impressions we acquire in our everyday lives, though sometimes correct, are often misleading. Experience shows that most Americans—not just students—either are unaware of or harbor grave misconceptions about some of the most basic economic facts. One popular myth holds that the United States is inundated with imported goods, mostly from China. Another is that business profits account for something like a third of the price we pay for a typical good or service. Also, "everyone knows" that federal government jobs have grown rapidly over the past few decades. In fact, none of these things is true.

So, before we begin to develop theories of how the economy works, it is useful to get an accurate picture of what our economy is really like.

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THE AMERICAN ECONOMY: A THUMBNAIL SKETCH

"And may we continue to be worthy of consuming a disproportionate share of this planet's resources."

The U.S. economy is the biggest national economy on earth, for two very different reasons. First, there are a lot of us. The population of the United States is approaching 300 million—making it the third most populous nation on earth after China (1.3 billion) and India (1.1 billion). That vast total includes children, retirees, full-time students, institutionalized people, and the unemployed, none of whom produce much output. But the *working population* of the United States numbers almost 140 million. As long as they are reasonably productive, that many people are bound to produce vast amounts of goods and services. And they do.

But population is not the main reason why the U.S. economy is by far the world's biggest. After all, India has nearly four times the population of the United States, but its economy is considerably smaller than that of Texas. The second reason why the U.S. economy is so large is that we are a very rich country. Because American workers are among the most productive in the world, our economy produces nearly $40,000 worth of goods and services for every living American—over $80,000 for every *working* American. If each of the 50 states was a separate country, California would be the fifth largest national economy on earth!

Inputs or **factors of production** are the labor, machinery, buildings, and natural resources used to make outputs.

Outputs are the goods and services that consumers and others want to acquire.

Why are some countries (like the United States) so rich and others (like India) so poor? That is one of the central questions facing economists. It is useful to think of an economic system as a machine that takes **inputs,** such as labor and other things we call **factors of production,** and transforms them into **outputs,** or the things people want to consume. The American economic machine performs this task with extraordinary efficiency, whereas the Indian machine runs quite inefficiently (though it is improving rapidly). Learning why this is so is one of the chief reasons to study economics.

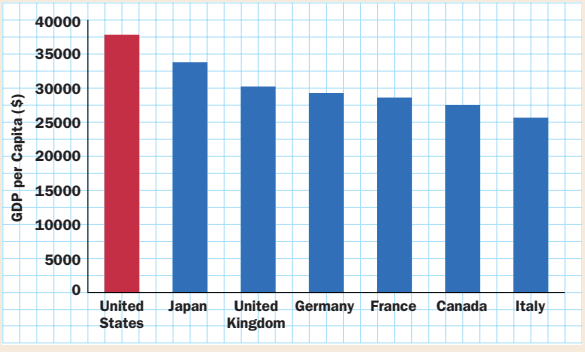
Thus, what makes the American economy the center of world attention is our unique combination of prosperity and population. There are other rich countries in the world, like Switzerland, and there are other countries with huge populations, like India. But no nation combines a huge population with high per-capita income the way the United States does. Japan, with an economy well under half the size of ours, is the only nation that comes close—although China, with its immense population, is moving up rapidly.

U.S. Share of World GDP—It's Nice To Be Rich

The 6.3 billion people of the world produced approximately $36 trillion worth of goods and services in 2003. The United States, with only 4.7 percent of that population, turned out just over 30 percent of total output, or over six times the average share. As the accompanying graph shows, the United States is still the leader in goods and services, with about $38,000 worth of GDP produced per person (or per capita). Just seven major industrial economies (the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada—which account for just under 12 percent of global population) generated 65 percent of world output.

SOURCE: International Monetary Fund, *World Economic Outlook Database, April 2004,* http://www.imf.org, accessed September 2004. Note: Foreign GDPs are converted to U.S. dollars using exchange rates.

2003 Gross Domestic Product (GDP) per Capita in 7 Industrial Countries



Although the United States is a rich and populous country, the 50 states certainly were not created equal. Population density varies enormously—from a high of nearly 1,200 people per square mile in crowded New Jersey to a low of just one person per square mile in the wide-open spaces of Alaska. Income variations are much less pronounced. But still, the average income in West Virginia, is only about half that in Connecticut.

A Private-Enterprise Economy

Part of the secret of America's economic success is that free markets and private enterprise have flourished here. These days more than ever, private enterprise and capitalism are the rule, not the exception, around the globe. But the United States has taken the idea of the free market further than almost any other country. It remains the "land of opportunity."

Every country has a mixture of public and private ownership of property. Even in the darkest days of communism, Russians owned their own personal possessions. In our country, the post office and the electricity-producing Tennessee Valley Authority are enterprises of the federal government, and many cities and states own and operate mass transit facilities and sports stadiums. But the United States stands out among the world's nations as one of the most "privatized." Few industrial assets are publicly owned in the United States. Even many city bus companies, and almost all utilities (such as electricity, gas, and telephones) are run as private companies in the United States. In Europe, they are often government enterprises, though there is substantial movement toward transfer of government firms to private ownership.

The United States also has one of the most "marketized" economies on earth. The standard measure of the total output of an economy is called **gross domestic product** (or **GDP**), a term that appears frequently in the news. The share of GDP that passes through markets in the United States is enormous. Although government purchases of goods and services amount to about 18 percent of GDP, much of that is purchased from private businesses. Direct government *production* of goods is extremely rare in our society.

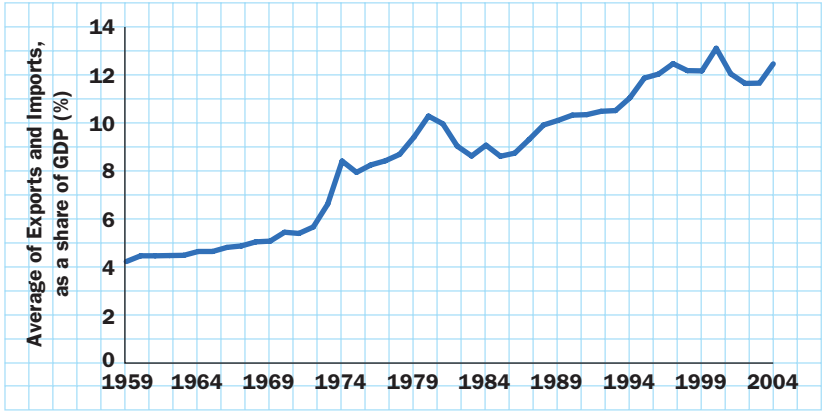
Gross domestic product (GDP) is a measure of the size of the economy—the total amount it produces in a year. *Real GDP* adjusts this measure for changes in the purchasing power of money, that is, it corrects for inflation.

A Relatively "Closed" Economy

All nations trade with one another, and the United States is no exception. Our annual exports exceed $1.2 trillion and our annual imports exceed $1.8 trillion. That's a lot of money. But America's international trade often gets more attention than it deserves. The fact is that we still produce most of what we consume and consume most of what we produce, although the shares of imports and exports have been growing, as Figure 1 shows. In 1959, the average of exports and imports was only about 4 percent of GDP, a tiny fraction of the total. It has since gone up to about 12 percent. This is no longer negligible, but it still means that about 88 percent of what Americans buy every year is made in the United States.

Among the most severe misconceptions about the U.S. economy is the myth that this country no longer manufactures anything but, rather, imports everything from, say, China. In fact, only about 14 percent of U.S. GDP is imported,

FIGURE 1 Share of U.S. Gross Domestic Product (GDP) Exported and Imported, 1959–2004



SOURCE: *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, various years).

with imports from China making up about one eighth of this—or less than 2 percent of GDP. It may surprise you to learn that we actually import far more merchandise from Canada than we do from China.

Economists use the terms *open* and *closed* to indicate how important international trade is to a nation. A common measure of "openness" is the average of exports and imports, expressed as a share of GDP. Thus, the Netherlands is considered an extremely **open economy** because it imports and exports about 51 percent of its GDP. (See Table 1.) By this criterion, the United States stands out as among the most **closed economies** of the advanced, industrial nations. We export and import a smaller share of GDP than most of the countries listed in the table.

An economy is called relatively **open** if its exports and imports constitute a large share of its GDP.

An economy is considered relatively **closed** if they constitute a small share.

A Growing Economy . . .

The next salient fact about the U.S. economy is its growth; it gets bigger almost every year (see Figure 2). Gross domestic product in 2004 was around $11.7 trillion; as noted earlier, that's about $40,000 per American. Measured in dollars of constant purchasing power,[1] the U.S. GDP was about 4.4 times as large in 2004 as it was in 1959. Of course, there were many more people in America in 2004 than there were 45 years earlier. But even correcting for population growth, America's real GDP *per capita* was about 2.7 times higher in 2004 than in 1959. That's still not a bad performance: Living standards nearly tripled in 45 years.

A **recession** is a period of time during which the total output of the economy falls.

TABLE 1

Openness of Various National Economies, 2003

	Openness
Netherlands	51%
Germany	28
Canada	27
United Kingdom	20
Mexico	18
United States	12
Japan	11
Russia	8
China	6

Note: Openness calculated as the average of imports and exports as a percentage of GDP.

SOURCE: For United States, *Economic Report of the President, 2004* (Washington, DC: U.S. Government Printing Office, Feb. 2004). For other countries, Central Intelligence Agency, *The World Factbook*, http://www.cia.org, accessed September 2004.

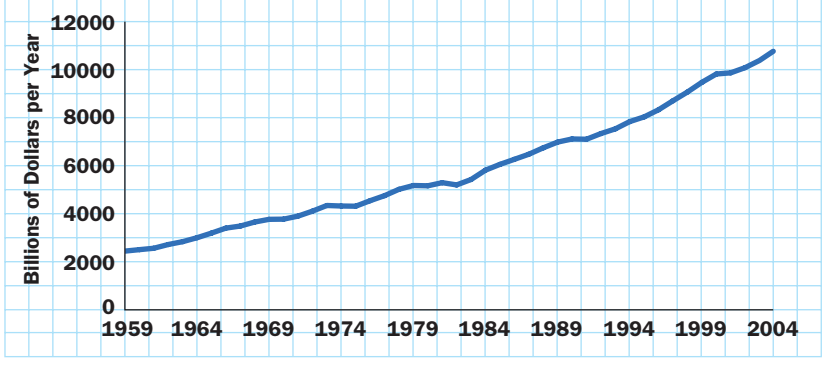
But with Bumps along the Growth Path

Although the cumulative growth performance depicted in Figure 2 is impressive, America's economic growth has been quite irregular. We have experienced alternating periods of good and bad times, which are called *economic fluctuations* or sometimes just *business cycles*. In some years—five since 1959, to be exact—GDP actually declined. Such periods of *declining* economic activity are called **recessions.**

The bumps along the American economy's historic growth path are barely visible in Figure 2. But they stand out more clearly in Figure 3, which displays the same data in a different way. Here we plot not the *level* of real GDP each year but, rather, its *growth rate*—the percentage change from one year to the next. Now the booms and busts that delight and distress people—and swing elections—stand out clearly. From 1983 to 1984, for example, real GDP grew by over 7 percent, which helped ensure Ronald Reagan's landslide reelection. But from 1990 to 1991, real GDP actually fell slightly, which helped Bill Clinton defeat (the first) George Bush.

One important consequence of these ups and downs in economic growth is that *unem-*

FIGURE 2 Real Gross Domestic Product (GDP) Since 1959



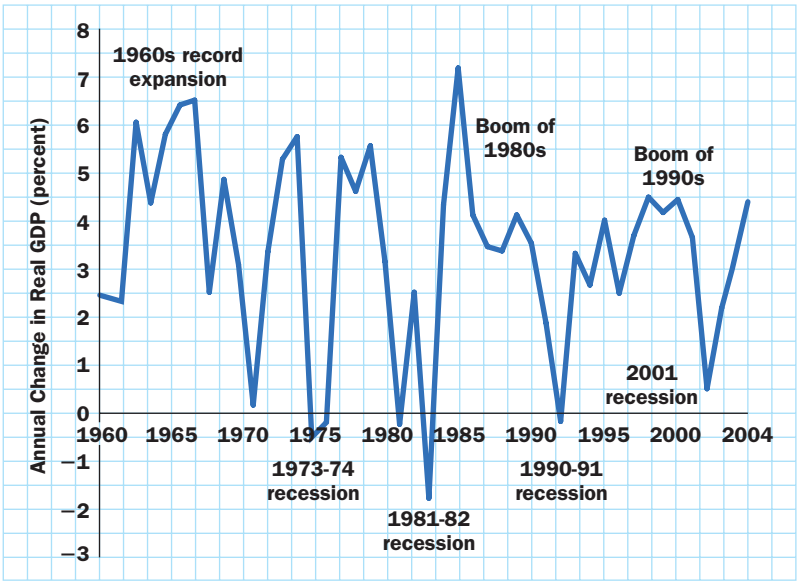
SOURCE: *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, various years).

Note: Real (inflation-adjusted) GDP figures are in 2000 dollars.

[1] This concept is called *real* GDP.

ployment varies considerably from one year to the next (see Figure 4). During the Great Depression of the 1930s, unemployment ran as high as 25 percent of the workforce. But it fell to barely over 1 percent during World War II. Just within the past few years, the national unemployment rate has been as high as 6.3 percent (in June 2003) and as low as 3.8 percent (in April 2000). In human terms, that 2.5 percentage point difference represents nearly four million jobless workers. Understanding why joblessness varies so dramatically, and what we can do about it, is another major reason for studying economics.

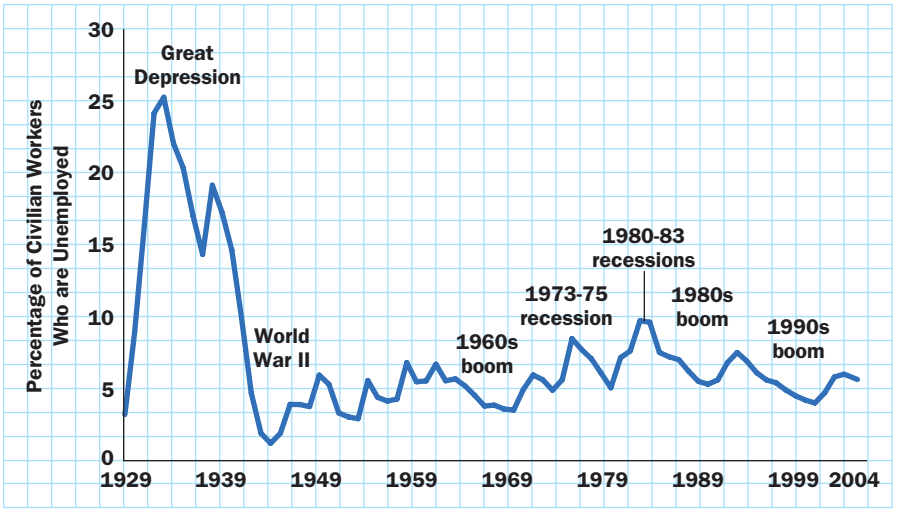
FIGURE 3 The Growth Rate of Real Gross Domestic Product (GDP) in the United States Since 1959



SOURCE: *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, various years)

Note: Growth rates are for 1959–1960, 1960–1961, and so on.

FIGURE 4 The Unemployment Rate in the United States, 1929–2004



SOURCE: *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, various years); and Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, DC: U.S. Government Printing Office, 1975).

THE INPUTS: LABOR AND CAPITAL

Let's now return to the analogy of an economy as a machine turning inputs into outputs. The most important input is human labor: the men and women who run the machines, work behind the desks, and serve you in stores.

The American Workforce: Who Is in It?

We have already mentioned that about 140 million Americans hold jobs. Fifty-three percent of these workers are men; 47 percent are women. This ratio represents a drastic change from two generations ago, when most women worked only at home (see Figure 5). Indeed, the massive entrance of women into the paid labor force was one

Unemployment Rates in Europe

For roughly the first quarter-century after World War II, unemployment rates in the industrialized countries of Europe were significantly lower than those in the United States. Then, in the mid-1970s, rates of joblessness in Europe leaped, with double digits becoming common. And they have been higher than U.S. unemployment rates more or less ever since. Where employment is concerned, the U.S. economy has become the envy of Europe—with the exception of the United Kingdom. Put on a comparable basis by the U.S. Bureau of Labor Statistics, unemployment rates in the various countries in the fall of 2004 were:

U.S.	5.5%
Canada	6.4
Australia	5.6
Japan	4.8
France	9.4
Germany	10.0
Italy	8.6*
Sweden	6.6
United Kingdom	4.7

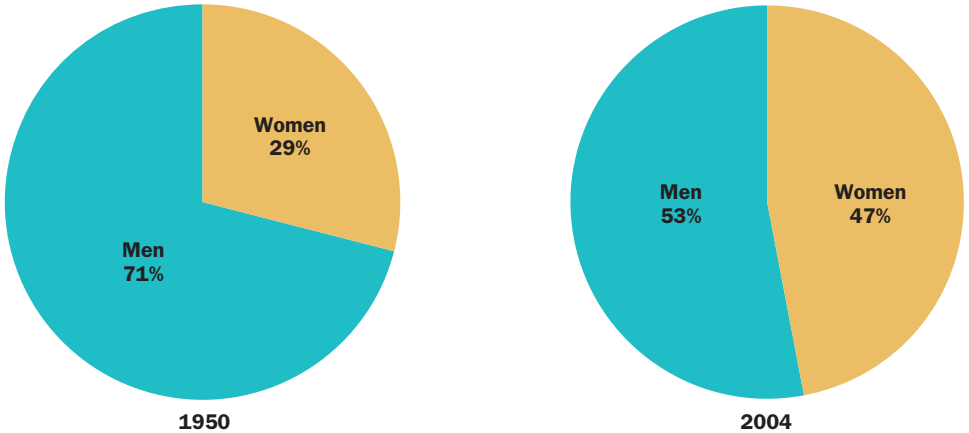
*1st quarter 2004

SOURCE: © Joel Stettenheim/Corbis

of the major social transformations of American life during the second half of the twentieth century. In 1950, just 29 percent of women worked in the marketplace; now about 60 percent do. As Figure 6 shows, the share of women in the labor forces of other industrial countries has also been growing. The expanding role of women in the labor market has raised many controversial questions—whether they are discriminated against (the evidence suggests that they are), whether the government should compel employers to provide maternity leave, and so on.

In contrast to women, the percentage of teenagers in the workforce has dropped significantly since its peak in the mid-1970s (see Figure 7). Young men and women aged

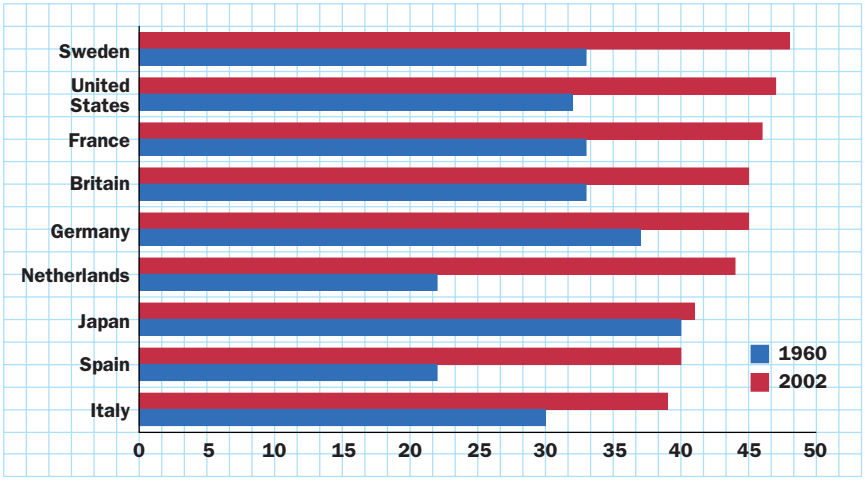
FIGURE 5 The Composition of Employment by Sex, 1950 and 2004.



SOURCE: *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, various years).

16 to 19 accounted for 8.6 percent of employment in 1974 but only 4.2 percent in 2004. As the baby boom gave way to the baby bust, people under 20 became scarce resources! Still, about six million teenagers hold jobs in the U.S. economy today—a number that has been pretty stable in the past few years. Most teenagers fill low-wage jobs at fast-food restaurants, amusement parks, and the like. Relatively few can be found in the nation's factories.

FIGURE 6 Working Women as a Percentage of the Labor Force, 1960 versus 2002

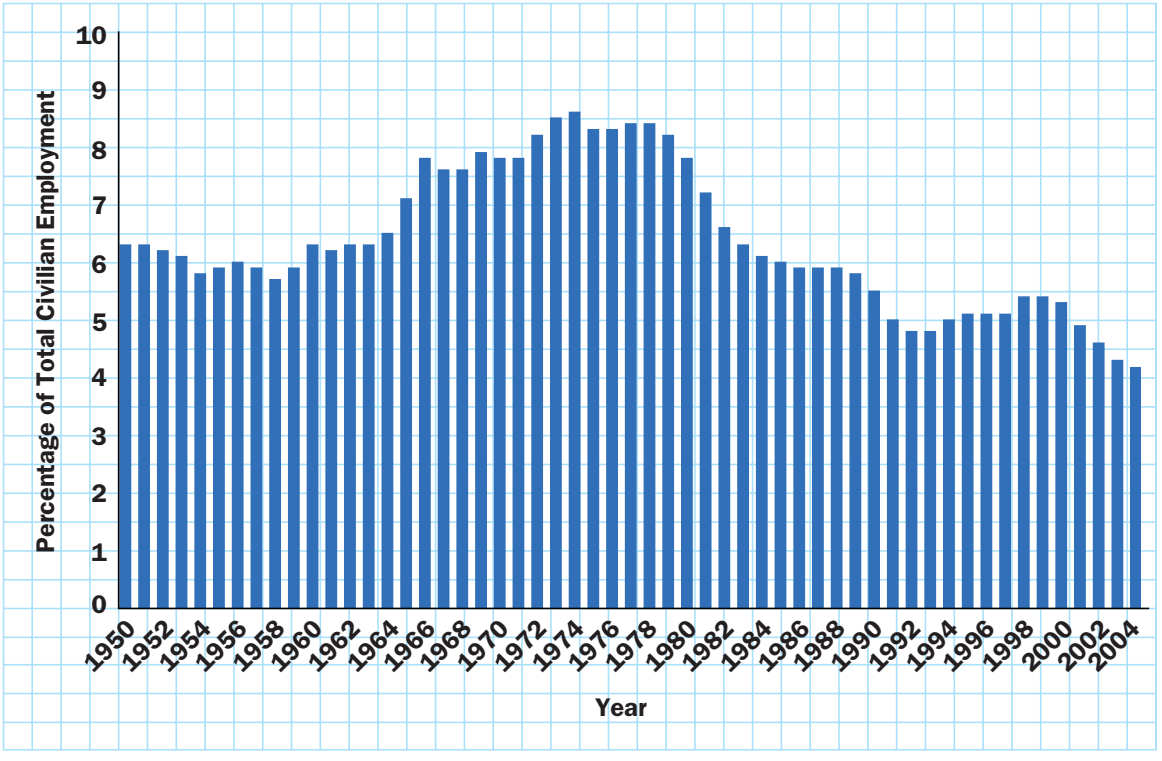


SOURCE: "A Survey of Women and Work," *The Economist*, July 18, 1998, p. 4; and Organization for Economic Cooperation and Development, *Labor Force Statistics, 2003*, http://new.sourceoecd.org, accessed September 2004.

The American Workforce: What Does It Do?

What do these 140 million working Americans do? The only real answer is: almost anything you can imagine. In 2003, America had 91,000 architects, 432,000 computer programmers, more than 852,000 carpenters, about 2.5 million truck drivers, 516,000 lawyers, roughly 3.9 million secretaries, 163,000 kindergarten teachers, 27,000 pediatricians, 50,000 tax preparers, 5,000 geological engineers, 273,000 firefighters, and 24,000 economists.[2]

FIGURE 7 Teenage Employment as a Percentage of Total Employment, 1950–2004



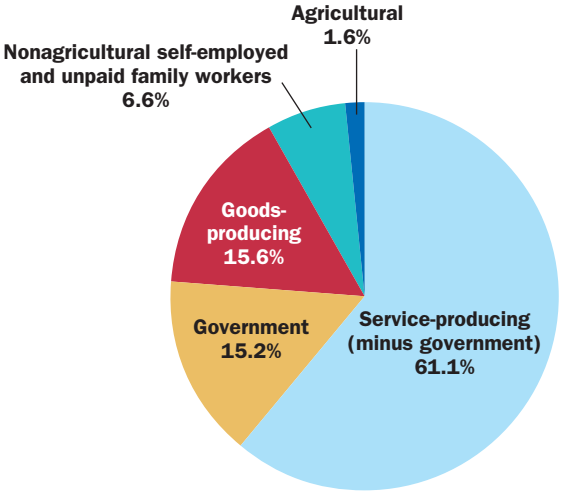
SOURCE: *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, various years).

[2] Source: U.S. Bureau of Labor Statistics, *Occupational Employment Statistics Survey 2003*, http://www.bls.gov, accessed September 2004.

Figure 8 shows the breakdown by sector. It holds some surprises for most people. The majority of American workers—like workers in all developed countries—produce services, not goods. In 2003, over 61 percent of all workers in the United States were employed by private service industries, whereas fewer than 16 percent produced goods. These legions of service workers included about 16.5 million in educational and health services, 16 million in business and professional services, and almost 15 million in retail trade. (The biggest single employer in the country is Wal-Mart.) By contrast, manufacturing companies in the United States employed only about 14.5 million people, and almost a third of those worked in offices rather than in the factory. The popular image of the typical American worker as a blue-collar worker—Homer Simpson, if you will—is really quite misleading.

Federal, state, and local governments employed about 21.5 million people but, contrary to another popular misconception, few of these civil servants work for the *federal* government. Federal *civilian* employment is about 2.7 million—and has been declining for about 15 years. (The armed forces employ about another 1.4 million men and women in uniform.) State and local governments provide nearly 19 million jobs—or about seven times the number of federal government jobs. Finally, approximately 2.3 million Americans work on farms and about 9.3 million are self-employed.

FIGURE 8 Civilian Employment by Sector, 2003

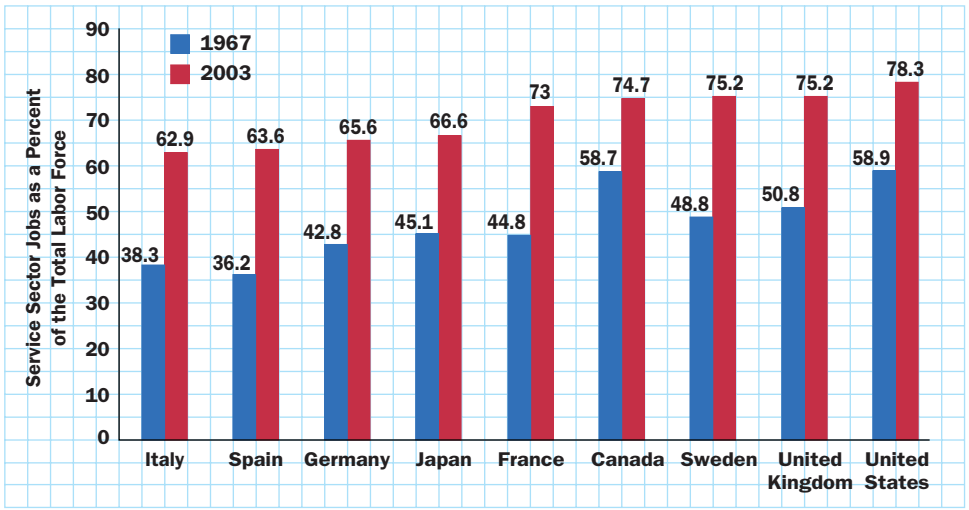


Note: Numbers may not add to 100% due to rounding.

SOURCE: Economic Report of the President, 2004 (Washington, DC: U.S. Government Printing Office, February 2004); and U.S. Department of Labor, Bureau of Labor Statistics, http://www.bls.gov, accessed September 2004. Agricultural and self-employed numbers from BLS community survey data.

As Figure 9 shows, *all* industrialized countries have become "service economies." To a considerable degree, this shift to services reflects the arrival of the "Information Age." Activities related to computers, to research, to the transmission of information by teaching and publication, and other information-related activities are providing many of the new jobs. This means that, in the rich economies, workers who moved out of manufacturing jobs into the service sectors have not gone predominantly into low-skill jobs such as dishwashing or housecleaning. Many found employment in service jobs in which education and experience provide a great advantage. At the same time, technological change has made it possible to produce more and more manufactured products using fewer and fewer workers.

FIGURE 9 The Growing Share of Service Sector Jobs, 1967 versus 2003



SOURCE: Organization for Economic Cooperation and Development, *Quarterly Labour Force Statistics, various issues; and OECD in Figures, 2004*, http://new.sourceoecd.org, accessed September 2004.

Such labor-saving innovation in manufacturing has allowed a considerable share of the labor force to move out of goods-producing jobs and into services.

The American Workforce: What It Earns

Altogether, these workers' wages account for over 70 percent of the income that the production process generates. That figures up to an average hourly wage of about $16—plus fringe benefits like health insurance and pensions, which can contribute an additional 30 to 40 percent for some workers. Because the average workweek is about 34 hours long, a typical weekly paycheck in the United States is about $540 before taxes (but excluding the value of benefits). That is hardly a princely sum, and most college graduates can expect to earn substantially more.[3] But it is typical of average wage rates in a rich country like the United States.

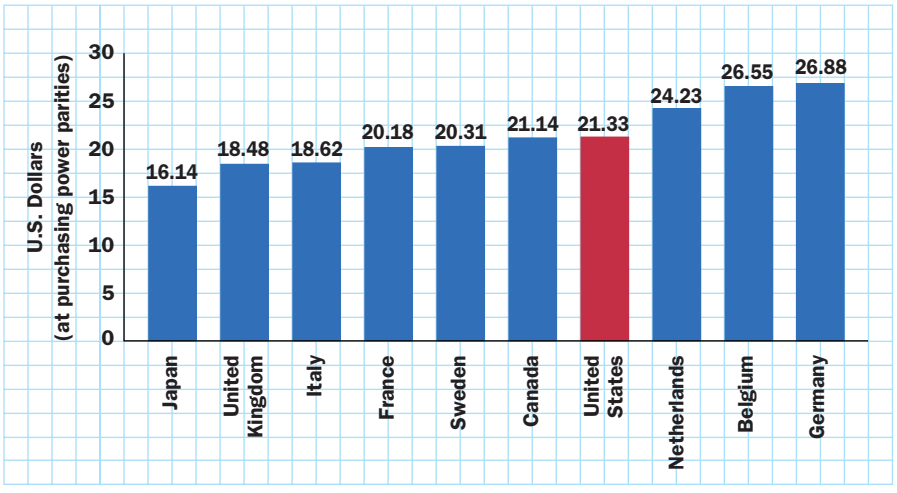
Wages throughout northern Europe are similar. Indeed, workers in a number of other industrial countries now receive higher compensation than American workers do—a big change from the situation a few decades ago. According to the U.S. Bureau of Labor Statistics, in 2002 workers in U.S. manufacturing industries made less than those in Germany, Belgium, and the Netherlands (see Figure 10). However, U.S. compensation levels still remain well above those in Japan, the United Kingdom, Italy, and many other countries.

Capital and Its Earnings

The rest of national income (after deducting for the sliver of income that goes to the owners of land and natural resources) mainly accrues to the owners of *capital*—the machines and buildings that make up the nation's industrial plant.

The total market value of these business assets—a tough number to estimate—is believed to be in the neighborhood of $30 trillion. Because that capital earns an average rate of return of about 10 percent before taxes, total earnings of capital come to about $3 trillion. Of this, corporate profits are less than half; the rest is mainly interest.

Public opinion polls routinely show that Americans have a distorted view of the level of business profits in our society. The man and woman on the street believe that profits account for about 30 percent of the price of a typical product (see the box "Public Opinion on Profits" on the next page). The right number is closer to 9 percent.



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, http://www.bls.gov; and Organization for Economic Cooperation and Development, *National Accounts of OECD Countries, Main Aggregates*, http://new.sourceoecd.org, accessed September 2004.

FIGURE 10
Average Hourly Compensation Rates in Manufacturing, 2002

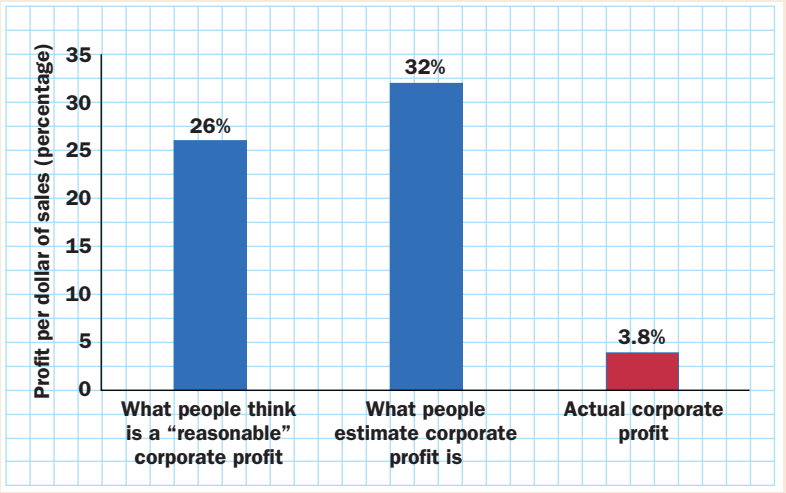
[3] These days, male college graduates typically earn about 80 percent more than men with only high school diplomas, and female college grads earn 75 percent more than high-school-educated women. Source: Lawrence Mishel, Jared Bernstein, and Heather Boushey, *The State of Working America, 2002/2003*, Ithaca, NY: ILR Press, Columbia University Press, 2003, pp. 160–161.

Public Opinion on Profits

Most Americans think corporate profits are much higher than they actually are. One public opinion poll years ago found that the average citizen thought that corporate profits *after taxes* amounted to 32 percent of sales for the typical manufacturing company. The actual profit rate at the time was closer to 4 percent!* Interestingly, when a previous poll asked how much profit was "reasonable," the response was 26 cents on every dollar of sales—more than six times as large as profits actually were.

*This poll was conducted in 1986. Corporate profit rates increased considerably in the 1990s and 2000s.

SOURCE: "Public Attitudes toward Corporate Profits," *Public Opinion Index* (Princeton, NJ: Opinion Research Corporation, June 1986).



THE OUTPUTS: WHAT DOES AMERICA PRODUCE?

What does all this labor and capital produce? Consumer spending accounts for about 70 percent of GDP. And what an amazing variety of goods and services it buys. American households spend roughly 60 percent of their budgets on services, with housing commanding the largest share. They also spend $130 billion annually on their telephone bills, $30 billion on airline tickets, and $75 billion on dentists. The other 40 percent of American budgets goes for goods—ranging from $100 billion per year on new cars to $50 billion on shoes.

This leaves about 30 percent of GDP for all *nonconsumption* uses. That includes government services (buying such things as airplanes, guns, and the services of soldiers, teachers, and bureaucrats), business purchases of machinery and industrial structures, and consumer purchases of new houses.

THE CENTRAL ROLE OF BUSINESS FIRMS

Calvin Coolidge once said that "the business of America is business." Although this statement often has been ridiculed, he was largely right. When we peer inside the economic machine that turns inputs into outputs, we see mainly private companies. Astonishingly, the United States has more than 25 million business firms—about one for every 12 people!

The owners and managers of these businesses hire people, acquire or rent capital goods, and arrange to produce things consumers want to buy. Sound simple? It isn't. Over 80,000 businesses fail every year. A few succeed spectacularly. Some do both. Fortunately for the U.S. economy, however, the lure of riches induces hundreds of thousands of people to start new businesses every year—against the odds.

A number of the biggest firms do business all over the world, just as foreign-based *multinational corporations* do business here. Indeed, some people claim that it is now impossible to determine the true "nationality" of a multinational corporation—which may have factories in ten or more countries, sell its wares all over the world, and have stockholders in dozens of nations. (See the accompanying box "Is That an American

Is That an American Company?

Robert Reich, who was Secretary of Labor in the Clinton administration, argued some years ago that it was already nearly impossible to define the nationality of a multinational company. Although many scholars think Reich exaggerated the point, no one doubts that he had one—nor that the nationalities of corporations have become increasingly blurred since then. He wrote in 1991:

> What's the difference between an "American" corporation that makes or buys abroad much of what it sells around the world and a "foreign" corporation that makes or buys in the United States much of what it sells? . . . The mind struggles to keep the players straight. In 1990, Canada's Northern Telecom was selling to its American customers telecommunications equipment made by Japan's NTT at NTT's factory in North Carolina.
>
> If you found that one too easy, try this: Beginning in 1991, Japan's Mazda would be producing Ford Probes at Mazda's plant in Flat Rock, Michigan. Some of these cars would be exported to Japan and sold there under Ford's trademark.
>
> A Mazda-designed compact utility vehicle would be built at a Ford plant in Louisville, Kentucky, and then sold at Mazda dealerships in the United States. Nissan, meanwhile, was designing a new light truck at its San Diego, California, design center. The trucks would be assembled at Ford's Ohio truck plant, using panel parts fabricated by Nissan at its Tennessee factory, and then marketed by both Ford and Nissan in the United States and in Japan. Who is Ford? Nissan? Mazda?

SOURCE: AP / Wide World Photos

SOURCE: Robert B. Reich, *The Work of Nations* (New York: Knopf, 1991), pp. 124, 131.

Company?") Most of General Motors' profits are generated abroad, for example, and the Honda you drive was probably assembled in Ohio.

Firms compete with other companies in their *industry*. Most economists believe that this *competition* is the key to industrial efficiency. A sole supplier of a commodity will find it easy to make money, and may therefore fail to innovate or control costs. Its management is liable to become relaxed and sloppy. But a company besieged by dozens of competitors eager to take its business away must constantly seek ways to innovate, to cut costs, and to build a better mousetrap. The rewards for business success can be magnificent. But the punishment for failure is severe.

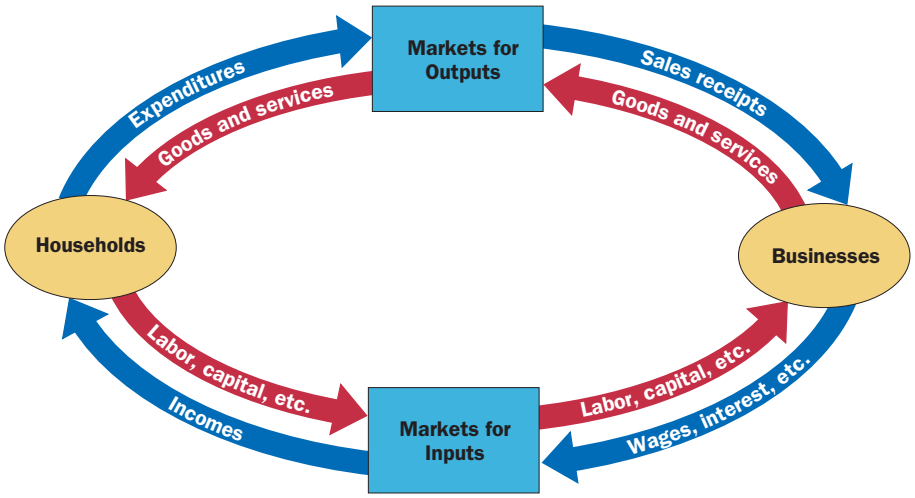
WHAT'S MISSING FROM THE PICTURE? GOVERNMENT

Thus far, we have the following capsule summary of how the U.S. economy works: About 25 million private businesses, energized by the profit motive, employ about 140 million workers and about $30 trillion of capital. These firms bring their enormously diverse wares to market, where they try to sell them to over 290 million consumers.

Households and businesses are linked in a tight circle, depicted in Figure 11. Firms use their receipts from sales to pay wages to employees and interest and profits to the people who provide capital. These income flows, in turn, enable consumers to purchase the goods and services that companies produce. This circular flow of money and goods lies at the center of the analysis of how the national economy works. All these activities are linked by a series of interconnected markets, some of which are highly competitive and others of which are less so.

All very well and good. But the story leaves out something important: the role of *government*, which is pervasive even in our decidedly free-market economy. Just what does government do in the U.S. economy—and why?

FIGURE 11 The Circular Flow of Goods and Money



Although an increasing number of tasks seem to get assigned to the state each year, the traditional role of government in a market economy revolves around five jobs:

- Making and enforcing the laws
- Regulating business
- Providing certain goods and services such as national defense
- Levying taxes to pay for these goods and services
- Redistributing income

Every one of these tasks is steeped in controversy and surrounded by intense political debate. We conclude this chapter with a brief look at each.

The Government as Referee

For the most part, power is diffused in our economy, and people "play by the rules." But, in the scramble for competitive advantage, disputes are bound to arise. Did Company A live up to its contract? Who owns that disputed piece of property? In addition, some unscrupulous businesses are liable to step over the line now and then—as we saw spectacularly in the series of scandals that rocked corporate America at the beginning of the twenty-first century.

Enter the government as rule maker, referee, and arbitrator. Congress and state and local legislatures pass the laws that define the rules of the economic game. The executive branches of all three governmental levels share the responsibility for enforcing them. And the courts interpret the laws and adjudicate disputes.

The Government as Business Regulator

Nothing is pure in this world of ours. Even in "free-market" economies, governments interfere with the workings of free markets in many ways and for myriad reasons. Some government activities seek to make markets work better. For example, America's *antitrust laws* are used to protect competition against possible encroachment by monopoly. Some regulations seek to promote social objectives that unfettered markets do not foster—environmental regulations are a particularly clear case. But, as critics like to point out, some economic regulations have no clear rationale at all.

We mentioned earlier that the American belief in free enterprise runs deep. For this reason, the regulatory role of government is more contentious here than in most other countries. After all, Thomas Jefferson said that government is best that governs

least. Two hundred years later, Presidents Reagan, Bush (both of them), and Clinton all pledged to dismantle inappropriate regulations—and sometimes did.

Government Expenditures

The most contentious political issues often involve taxing and spending because those are the government's most prominent roles. Democrats and Republicans, both in the White House and in Congress, have frequently battled fiercely over the federal budget. In 1995 and 1996, such disputes even led to some temporary shutdowns of the government. Under President Bill Clinton, the federal government managed to achieve a sizable surplus in its budget—meaning that tax receipts exceeded expenditures. But it didn't last long. Today the federal budget is deeply in the red, and prospects for getting it balanced are poor.

During fiscal year 2004, the federal government spent more than $2.3 *trillion*—a sum that is literally beyond comprehension. Figure 12 shows where the money went. Over 37 percent went for *pensions and income security* programs, which include both social insurance programs (such as Social Security and unemployment compensation) and programs designed to assist the poor. About 19 percent went for *national defense*. Another 22 percent was absorbed by *health-care* expenditures, mainly on Medicare and Medicaid. Adding in *interest on the national debt*, these four functions alone accounted for about 85 percent of federal spending. The rest went for a miscellany of other purposes including education, transportation, agriculture, housing, and foreign aid.

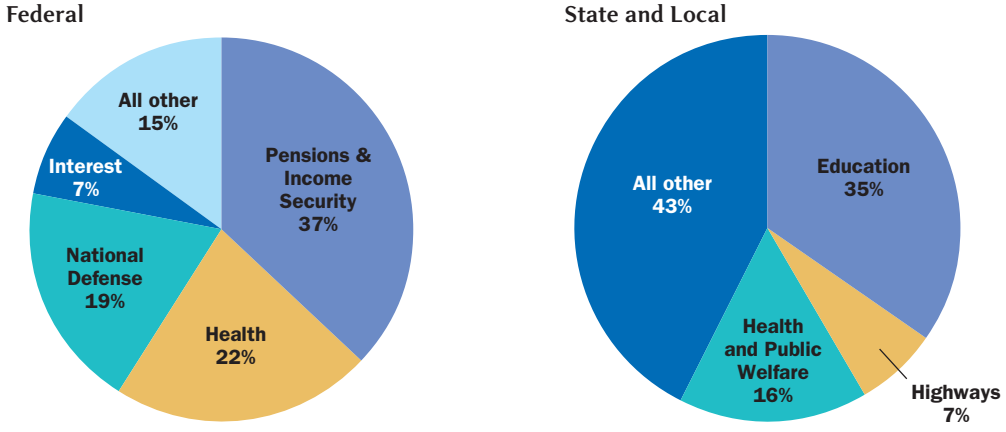
Government spending at the state and local levels was about $1.8 trillion in 2004. Education claimed the largest share of state and local government budgets (35 percent), with health and public welfare programs a distant second (16 percent). Despite this vast outpouring of public funds, many observers believe that serious social needs remain unmet. Critics claim that our public infrastructure (such as bridges and roads) is adequate, that our educational system is lacking, that we are not spending enough on homeland defense, and so on.

Although the scale and scope of government activity in the United States is substantial, it is quite moderate when we compare it to other leading economies. Figure 13 is a bar graph showing government expenditure as share of GDP for ten rich countries. We see that the share of government in the U.S. economy is the lowest in this group of countries.

Taxes in America

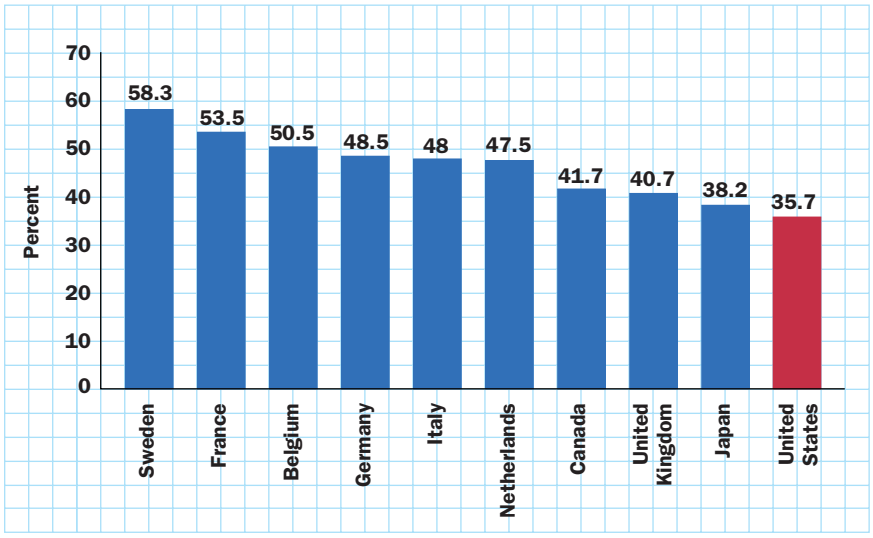
Taxes finance this array of goods and services, and sometimes it seems that the tax collector is everywhere. We have income and payroll taxes withheld from our paychecks,

FIGURE 12 The Allocation of Government Expenditures



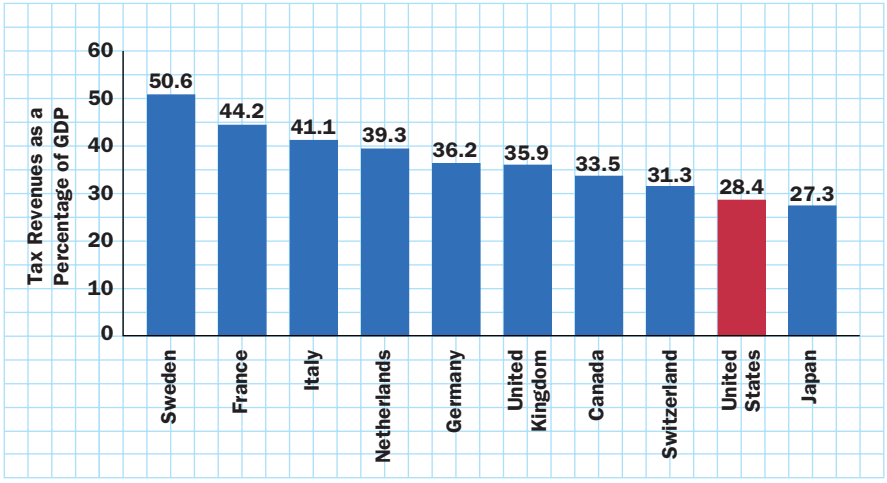
SOURCE: *Economic Report of the President, 2004* (Washington, DC: U.S. Government Printing Office, February 2004).

FIGURE 13 Government Spending as a Percentage of GDP, 2002



SOURCE: Organization for Economic Cooperation and Development, *OECD in Figures, 2004*, http://new.sourceoecd.org, accessed September 2004.

FIGURE 14 The Tax Burden in Selected Countries, 2002



SOURCE: Organization for Economic Cooperation and Development, *Revenue Statistics, 1965-2002* (Paris: OECD, 2003), http://new.sourceoecd.org, accessed October 2004.

sales taxes added to our purchases, property taxes levied on our homes; we pay gasoline taxes, liquor taxes, and telephone taxes.

Americans have always felt that taxes are both too many and too high. In the 1980s and 1990s, antitax sentiment became a dominant feature of the U.S. political scene. The old slogan "no taxation without representation" gave way to the new slogan "no new taxes." Yet, by international standards, Americans are among the most lightly taxed people in the world. Figure 14 compares the fraction of income paid in taxes in the United States with those paid by residents of other wealthy nations. The tax share in the United States has fallen notably during the presidency of George W. Bush.

The Government as Redistributor

In a market economy, people earn incomes according to what they have to sell. Unfortunately, many people have nothing to sell but unskilled labor, which commands a paltry price. Others lack even that. Such people fare poorly in unfettered markets. In extreme cases, they are homeless, hungry, and ill. Robin Hood transferred money from the rich to the poor. Some think the government should do the same; others disagree.

If poverty amid riches offends your moral sensibilities—a personal judgment that each of us must make for ourselves—two basic remedial approaches are possible. The socialist idea is to force the distribution of income to be more equal by overriding the decisions of the market. "From each according to his ability, to each according to his needs" was Marx's ideal. In practice, things were not quite so noble under socialism. But there is little doubt that incomes in the old Soviet Union were more equally distributed than those in the United States.

The liberal idea is to let free markets determine the distribution of *before-tax* incomes, but then to use the tax system and **transfer payments** to reduce inequality—just as Robin Hood did. This is the rationale for, among other things, **progressive taxation** and the antipoverty programs colloquially known as "welfare." Americans who support redistribution line up solidly behind the liberal approach. But which ways are the best, and how much is enough? No simple answers have emerged from debate on these highly contentious questions.

Transfer payments are sums of money that certain individuals receive as outright grants from the government rather than as payments for services rendered.

A tax is **progressive** if the ratio of taxes to income rises as income rises.

CONCLUSION: IT'S A MIXED ECONOMY

Ideology notwithstanding, all nations at all times blend public and private ownership of property in some proportions. All rely on markets for some purposes, but all also assign some role to government. Hence, people speak of the ubiquity of **mixed economies.** But mixing is not homogenization; different countries can and do blend the state and market sectors in different ways. Even today, the Russian economy is a far cry from the Italian economy, which is vastly different from that of Hong Kong.

When most of you were very young children, a stunning historical event occurred: Communism collapsed all over Europe. For years, the formerly socialist economies suffered through a painful transition from a system in which private property, free enterprise, and markets played subsidiary roles to one in which they are central. These nations have changed the mix, if you will—and dramatically so. To understand why this transformation is at once so difficult and so important, we need to explore the main theme of this book: *What does the market do well, and what does it do poorly?* This task begins in the next chapter.

A **mixed economy** is one with some public influence over the workings of free markets. There may also be some public ownership mixed in with private property.

SUMMARY

1. The U.S. economy is the biggest national economy on earth, both because Americans are rich by world standards and because we are a populous nation. Relative to most other advanced countries, our economy is also exceptionally "privatized" and **closed**.
2. The U.S. economy has grown dramatically over the years. But this growth has been interrupted by periodic **recessions,** during which unemployment rises.
3. The United States has a big, diverse workforce whose composition by age and sex has been changing substantially. Relatively few workers these days work in factories or on farms; most work in service industries.
4. Employees take home most of the nation's income. Most of the rest goes, in the forms of interest and profits, to those who provide the capital.
5. Governments at the federal, state, and local levels employ one-sixth of the American workforce (including the armed forces). These governments finance their expenditures by taxes, which account for about 28 percent of GDP. This percentage is one of the lowest in the industrialized world.
6. In addition to raising taxes and making expenditures, the government in a market economy serves as referee and enforcer of the rules, regulates business in a variety of ways, and redistributes income through taxes and **transfer payments.** For all these reasons, we say that we have a **mixed economy,** which blends private and public elements.

KEY TERMS

Factors of Production, or Inputs 20
Outputs 20
Gross domestic product (GDP) 21
Open economy 22
Closed economy 22
Recession 22
Transfer payments 32
Progressive tax 32
Mixed economy 33

DISCUSSION QUESTIONS

1. Which are the two biggest national economies on earth? Why are they so much bigger than the others?
2. What is meant by a "factor of production?" Have you ever sold any on a market?
3. Why do you think per-capita income in Connecticut is nearly double that in West Virginia?
4. Roughly speaking, what fraction of U.S. labor works in factories? In service businesses? In government?
5. Most American businesses are small, but most of the output is produced by large businesses. That sounds paradoxical. How can it be true?
6. What is the role of government in a mixed economy?