Economics, the Enterprise System, and Finance

by Jonathan D. Kantrowitz

Class Pack ISBN: 978-0-7827-2541-4 • Student Book ISBN: 978-0-7827-2540-7 •

Queue, Inc. • 80 Hathaway Drive, Stratford, CT 06615
(800) 232-2224 • Fax: (800) 775-2729 • www.qworkbooks.com

Table of Contents

1. How the U.S. Economy Works

In every economic system, entrepreneurs and managers bring together natural resources, labor, and technology to produce and distribute goods and services. But the way these different elements are organized and used also reflects a nation's political ideals and its culture.

The United States is often described as a "capitalist" economy, a term coined by 19th-century German economist and social theorist Karl Marx to describe a system in which a small group of people who control large amounts of money, or capital, make the most important economic decisions. Marx contrasted capitalist economies to "socialist" ones, which vest more power in the political system. Marx and his followers believed that capitalist economies concentrate power in the hands of wealthy business people, who aim mainly to maximize profits; socialist economies, on the other hand, would be more likely to feature greater control by government, which tends to put political aims — a more equal distribution of society's resources, for instance — ahead of profits.

While those categories, though oversimplified, have elements of truth to them, they are far less relevant today. If the pure capitalism described by Marx ever existed, it has long since disappeared, as governments in the United States and many other countries have intervened in their economies to limit concentrations of power and address many of the social problems associated with unchecked private commercial interests. As a result, the American economy is perhaps better described as a "mixed" economy, with government playing an important role along with private enterprise.

Although Americans often disagree about exactly where to draw the line between their beliefs in both free enterprise and government management, the mixed economy they have developed has been remarkably successful.

Basic Ingredients of the U.S. Economy

The first ingredient of a nation's economic system is its land, or natural resources. The United States is rich in mineral resources and fertile farm soil, and it is blessed with a moderate climate. It also has extensive coastlines on both the Atlantic and Pacific Oceans, as well as on the Gulf of Mexico. Rivers flow from far within the continent, and the Great Lakes — five large, inland lakes along the U.S. border with Canada — provide additional shipping access. These extensive waterways have helped shape the country's economic growth over the years and helped bind America's 50 individual states together in a single economic unit.

The second ingredient is labor, which converts natural resources into goods. The number of available workers and, more importantly, their productivity help determine the health of an economy. Throughout its history, the United States has experienced steady growth in the labor force, and that, in turn, has helped fuel almost constant economic expansion. Until shortly after World War I, most workers were immigrants from Europe, their immediate descendants, or African-Americans whose ancestors were brought to the Americas as slaves. In the early years of the 20th century, large numbers of Asians immigrated to the United States, while many Latin American immigrants came in later years.

Although the United States has experienced some periods of high unemployment and other times when labor was in short supply, immigrants tended to come when jobs were plentiful. Often willing to work at jobs other workers decline to do, they generally prospered, earning far more than they would have in their native lands. The nation prospered as well, so that the economy grew fast enough to absorb even more newcomers.

Labor mobility has likewise been important to the capacity of the American economy to adapt to changing conditions. When immigrants flooded labor markets on the East Coast, many workers moved inland, often to farmland waiting to be tilled. Similarly, economic opportunities in industrial, northern cities attracted black Americans from southern farms in the first half of the 20th century.

Labor-force quality continues to be an important issue. Today, Americans consider "human capital" a key to success in numerous modern, high-technology industries. As a result, government leaders and business officials increasingly stress the importance of education and training to develop workers with the kind of nimble minds and adaptable skills needed in new industries such as computers and telecommunications.

Capital and management are the third and fourth basic ingredients of a productive economy. The United States has been blessed with efficient capital markets that provide funds for new and existing businesses to expand in a myriad of ways. Entrepreneurship is a strong tradition in America as well, with individuals from all walks of life ready and eager to strike off on their own, to start or acquire business enterprises. Management of larger businesses has had a more mixed record in recent years.

In addition to its natural resources, the United States' large size offers many economic advantages — uniform laws, language, currency and culture allow much easier movement of goods, labor and capital than among smaller independent economies. In Europe, the Common Market has recognized these advantages and attempted to emulate them, with mixed success.

1. In the 20th and 21st centuries, immigrants to the US have been motivated primarily by __________ reasons

   a. religious
   b. political
   c. economic
   d. adventurous

2. Which of the following countries most nearly parallels America's economic advantages listed above?

   a. England
   b. China
   c. Japan
   d. Belgium

3. America's economy can best be described as

   a. capitalist.
   b. unionist.
   c. socialist.
   d. mixed.

4. Prior to the 20th century, one of the principal sources of labor in America was all of the following and their descendants except

   a. slaves forcefully imported.
   b. immigrants fleeing religious persecution.
   c. immigrants seeking economic opportunity.
   d. immigrants seeking a better education.

5. Which of the four basic ingredients of America's economy — land, labor, capital and management — do you think has been most crucial to the growth of America's economy? Use specific evidence from the text to support your answer.

A Mixed Economy: The Role of the Market

The United States is said to have a mixed economy because privately owned businesses and government both play important roles. Indeed, some of the most enduring debates of American economic history focus on the relative roles of the public and private sectors.

The American free enterprise system emphasizes private ownership. Private businesses produce most goods and services, and almost two-thirds of the nation's total economic output goes to individuals for personal use (the remaining one-third is bought by government and business). The consumer role is so great, in fact, that the nation is sometimes characterized as having a "consumer economy."

This emphasis on private ownership arises, in part, from American beliefs about personal freedom. From the time the nation was created, Americans have feared excessive government power, and they have sought to limit government's authority over individuals — including its role in the economic realm. In addition, Americans generally believe that an economy characterized by private ownership is likely to operate more efficiently than one with substantial government ownership.

There are limits to free enterprise, however. Americans have always believed that some services are better performed by public rather than private enterprise. For instance, in the United States, government is primarily responsible for the administration of justice, education (although there are many private schools and training centers), the road system, social statistical reporting, and national defense.

In addition, government often is asked to intervene in the economy to correct situations in which the price system does not work. It regulates "natural monopolies," for example, and it uses antitrust laws to control or break up other business combinations that become so powerful that they can surmount market forces.

Government also addresses issues beyond the reach of market forces. It provides welfare and unemployment benefits to people who cannot support themselves, either because they encounter problems in their personal lives or lose their jobs as a result of economic upheaval; it pays much of the cost of medical care for the aged and those who live in poverty; it regulates private industry to limit air and water pollution; it provides low-cost loans to people who suffer losses as a result of natural disasters; and it has played the leading role in the exploration of space, which is too expensive for any private enterprise to handle.

In this mixed economy, individuals can help guide the economy not only through the choices they make as consumers but through the votes they cast for officials who shape economic policy. In recent years, consumers have voiced concerns about product safety, environmental threats posed by certain industrial practices, and potential health risks citizens may face; government has responded by creating agencies to protect consumer interests and promote the general public welfare.

The U.S. economy has changed in other ways as well. The population and the labor force have shifted dramatically away from farms to cities, from fields to factories, and, above all, to service industries. In today's economy, the providers of personal and public services far outnumber producers of agricultural and manufactured goods.

Government's Role in the Economy

While consumers and producers make most decisions that mold the economy, government activities have a powerful effect on the U.S. economy in at least four areas.

Stabilization and Growth

Perhaps most importantly, the federal government guides the overall pace of economic activity, attempting to maintain steady growth, high levels of employment, and price stability. By adjusting spending and tax rates (fiscal policy) or managing the money supply and controlling the use of credit (monetary policy), it can slow down or speed up the economy's rate of growth — in the process, affecting the level of prices and employment.

For many years following the Great Depression of the 1930s, recessions — periods of slow economic growth and high unemployment — were viewed as the greatest of economic threats. When the danger of recession appeared most serious, government sought to strengthen the economy by spending heavily itself or cutting taxes so that consumers would spend more, and by fostering rapid growth in the money supply, which also encouraged more spending. In the 1970s, major price increases, particularly for energy, created a strong fear of inflation — increases in the overall level of prices. As a result, government leaders came to concentrate more on controlling inflation than on combating recession by limiting spending, resisting tax cuts, and reining in growth in the money supply.

Ideas about the best tools for stabilizing the economy changed substantially between the 1960s and the 1990s. In the 1960s, government had great faith in fiscal policy — manipulation of government revenues to influence the economy. Since spending and taxes are controlled by the president and the Congress, these elected officials played a leading role in directing the economy. A period of high inflation, high unemployment, and huge government deficits weakened confidence in fiscal policy as a tool for regulating the overall pace of economic activity. Instead, monetary policy — controlling the nation's money supply through such devices as interest rates — assumed growing prominence. Monetary policy is directed by the nation's central bank, known as the Federal Reserve Board, with considerable independence from the president and the Congress.

Regulation and Control

The U.S. federal government regulates private enterprise in numerous ways. Regulation falls into two general categories. Economic regulation seeks, either directly or indirectly, to control prices. Traditionally, the government has sought to prevent monopolies such as electric utilities from raising prices beyond the level that would ensure them reasonable profits. At times, the government has extended economic control to other kinds of industries as well. In the years following the Great Depression, it devised a complex system to stabilize prices for agricultural goods, which tend to fluctuate wildly in response to rapidly changing supply and demand. A number of other industries — trucking and, later, airlines — successfully sought regulation themselves to limit what they considered harmful price-cutting.

Another form of economic regulation, antitrust law, seeks to strengthen market forces so that direct regulation is unnecessary. The government — and, sometimes, private parties — have used antitrust law to prohibit practices or mergers that would unduly limit competition.

Government also exercises control over private companies to achieve social goals, such as protecting the public's health and safety or maintaining a clean and healthy environment. The U.S. Food and Drug Administration bans harmful drugs, for example; the Occupational Safety and Health Administration protects workers from hazards they may encounter in their jobs; and the Environmental Protection Agency seeks to control water and air pollution.

American attitudes about regulation changed substantially during the final three decades of the 20th century. Beginning in the 1970s, policy-makers grew increasingly concerned that economic regulation protected inefficient companies at the expense of consumers in industries such as airlines and trucking. At the same time, technological changes spawned new competitors in some industries, such as telecommunications, that once were considered natural monopolies. Both developments led to a succession of laws easing regulation.

While leaders of both political parties generally favored economic deregulation during the 1970s, 1980s, and 1990s, there was less agreement concerning regulations designed to achieve social goals. Social regulation had assumed growing importance in the years following the Depression and World War II, and again in the 1960s and 1970s. But during the presidency of Ronald Reagan in the 1980s, the government relaxed rules to protect workers, consumers, and the environment, arguing that regulation interfered with free enterprise and increased the costs of doing business. Still, many Americans continued to voice concerns about specific events or trends, prompting the government to issue new regulations in some areas, including environmental protection.

Some citizens, meanwhile, have turned to the courts when they feel their elected officials are not addressing certain issues quickly or strongly enough. For instance, in the 1990s, individuals, and eventually government itself, sued tobacco companies over the health risks of cigarette smoking. A large financial settlement provided states with long-term payments to cover medical costs to treat smoking-related illnesses.

Direct Services

Each level of government provides many direct services. The federal government, for example, is responsible for national defense, backs research that often leads to the development of new products, conducts space exploration, and runs numerous programs designed to help workers develop workplace skills and find jobs. Government spending has a significant effect on local and regional economies — and even on the overall pace of economic activity.

State governments, meanwhile, are responsible for the construction and maintenance of most highways. State, county, or city governments play the leading role in financing and operating public schools. Local governments are primarily responsible for police and fire protection. Government spending in each of these areas can also affect local and regional economies, although federal decisions generally have the greatest economic impact.

Overall, federal, state, and local spending accounted for almost 18 percent of gross domestic product in 1997.

Direct Assistance

Government also provides many kinds of help to businesses and individuals. It offers low-interest loans and technical assistance to small businesses, and it provides loans to help students attend college. Government-sponsored enterprises buy home mortgages from lenders and turn them into securities that can be bought and sold by investors, thereby encouraging home lending. Government also actively promotes exports and seeks to prevent foreign countries from maintaining trade barriers that restrict imports.

Government supports individuals who cannot adequately care for themselves. Social Security, which is financed by a tax on employers and employees, accounts for the largest portion of Americans' retirement income. The Medicare program pays for many of the medical costs of the elderly. The Medicaid program finances medical care for low-income families. In many states, government maintains institutions for the mentally ill or people with severe disabilities. The federal government provides assistance to help poor families obtain food, and the federal and state governments jointly provide welfare grants to support low-income parents with children. The government also provides unemployment insurance to those who have lost jobs.

Many of these programs, including Social Security, trace their roots to the "New Deal" programs of Franklin D. Roosevelt, who served as the U.S. president from 1933 to 1945. Key to Roosevelt's reforms was a belief that poverty usually resulted from social and economic causes rather than from failed personal morals. This view repudiated a common notion whose roots lay in New England Puritanism that success was a sign of God's favor and failure a sign of God's displeasure. This was an important transformation in American social and economic thought. Even today, however, echoes of the older notions are still heard in debates around certain issues, especially welfare.

Many other assistance programs for individuals and families, including Medicare and Medicaid, were begun in the 1960s during President Lyndon Johnson's (1963-1969) "War on Poverty." Although some of these programs encountered financial difficulties in the 1990s and various reforms were proposed, they continued to have strong support from both of the United States' major political parties. Critics argued, however, that providing welfare to unemployed but healthy individuals actually created dependency rather than solving problems. Welfare reform legislation enacted in 1996 under President Bill Clinton (1993-2001) requires people to work as a condition of receiving benefits and imposes limits on how long individuals may receive payments.

1. The most influential factor in America's mixed economy is the

   a. consumer.
   b. government.
   c. manufacturers.
   d. service providers.

2. For the vast majority of American workers, the government policy most directly affecting them is

   a. monetary policies.
   b. spending levels.
   c. tax policies.
   d. unemployment insurance.

3. Special interests in America spend vast amounts of money on lobbying, political contributions, and direct appeal to the public to shape government spending and taxation policies as well as laws and regulations. Choose an interest group to represent, and describe how your group would like to change how the government treats a certain part of the economy. Use specific evidence from the text in your response.

