Chapter 3 American Free Enterprise

In the United States, economic opportunity is abundantly evident, from corporate headquarters in gleaming cities like Miami, shown here, to neighborhood mom-and-pop businesses, to drive-through franchises in suburban strip malls. This chapter examines the benefits of American free enterprise and the factors that make it so prosperous, adaptive, and enduring.

Economics Journal

In what ways do the benefits of free enterprise affect your daily life? List as many examples as you can. Consider neighborhood businesses, jobs you have held, and other ways in which you benefit from our nation's prosperity.

Go Online PHSchool.com

For: Current Data
Visit: PHSchool.com
Web Code: mng-1031

Section 1 Benefits of Free Enterprise

Preview

Objectives

After studying this section you will be able to:

1. **Describe** the tradition of free enterprise in the United States and the constitutional protections that underlie it.
2. **Explain** the basic principles of the U.S. free enterprise system.
3. **Identify** the role of the consumer in the U.S. free enterprise system.
4. **Describe** the role of the government in the U.S. free enterprise system.

Section Focus

American free enterprise is based on the principles of profit motive, voluntary exchange, private property rights, competition, and freedom for producers and consumers. The U.S. Constitution supports the free enterprise system by guaranteeing private property rights, the right to make contracts, and freedom from unfair taxation.

Key Terms

profit motive
open opportunity
private property rights
free contract
voluntary exchange
competition
interest group
public disclosure laws
public interest

Some of the most famous Americans have not been politicians, sports figures, or actors. Do you recognize names like John D. Rockefeller, founder of Standard Oil of New Jersey, or Andrew Carnegie, who started Carnegie Steel Company, or Bill Gates, the founder of Microsoft? Each of these people started with an idea and through persistence, vision, and effort built that idea into a huge business success. They made themselves into the richest people of their time, helped fuel the economy, and contributed vast sums of money to programs and charities for the public good.

A Tradition of Free Enterprise

Today there are over 18 million unincorporated businesses in America, including about 3 million minority-owned businesses. Many of these were started by a single entrepreneur or a small group of friends or family members hoping to earn a living and, perhaps, become successful or even wealthy.

For centuries, people have considered America to be a "land of opportunity"—a place where anyone from any background could achieve success through hard work. Although immigrants no longer expect to find streets paved with gold, this country does offer special opportunities that have allowed business people to be so successful and have contributed to our overall economic prosperity.

Why has America been such an economic success? Certainly the open land, natural resources, and uninterrupted flow of immigrants with different backgrounds and experiences all contribute. But a key factor has also been the American tradition of free enterprise—the social and political commitment to giving people the freedom

▼ How does this photo represent the American free enterprise system?

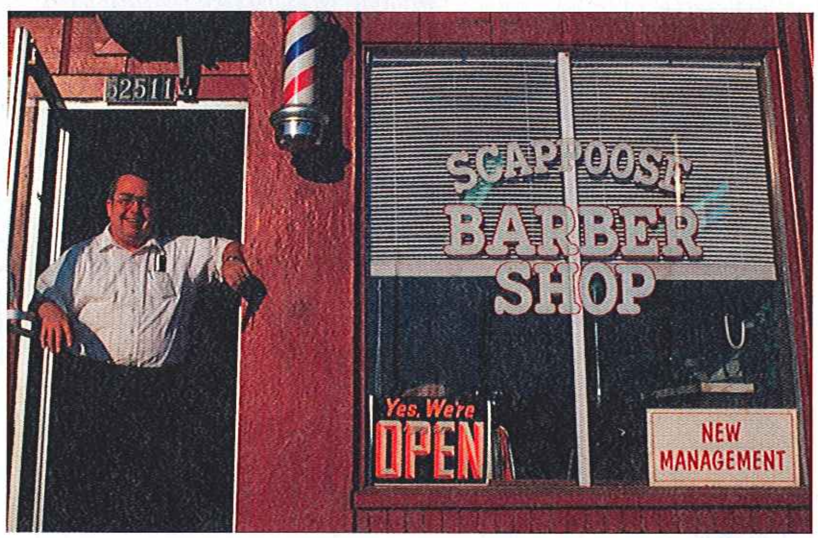
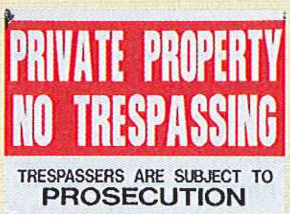


Figure 3.1 Features of American Free Enterprise

Economic Freedom *In the United States, individuals have the right to choose their occupations and to work wherever they can find jobs. Businesses can make their own decisions on whom to hire, what to produce, how much to produce, and how much to charge for their products and services. The government generally does not interfere in these decisions.*

Competition *Producers have the right to engage in rivalries to gain business. Competing producers have an incentive to create new and better products. This gives consumers more economic choices.*



Private Property *Individuals and businesses have the right to buy and sell as much property as they want. Property owners may prohibit others from using their property.*

Contracts *Individuals and businesses have the right to make agreements to buy and sell goods. Such contracts may be written or oral. They are legally binding.*

Self-Interest *Consumers and producers may make decisions on the basis of their own benefit. Their decisions do not have to benefit or please the government or other consumers and producers.*

Voluntary Exchange *Consumers and producers may freely buy and sell goods when the opportunity costs of such exchanges are worthwhile. In a voluntary exchange, both parties expect to gain from the transaction.*

Profit Motive *American free enterprise is driven by the desire for profit, the gain that occurs during financial dealings. Profit is a powerful incentive that leads entrepreneurs and businesses to accept the risk of business failure.*

BUILDING KEY CONCEPTS

Free enterprise in America is founded on ideas so basic to our culture that we tend to take them for granted. **Government Choose one of these features and give an example from your own daily life.**

and flexibility to try out their business ideas and compete in the marketplace.

Constitutional Protections

The Bill of Rights to the United States Constitution guarantees certain individual freedoms, such as freedom of speech and freedom of religion. The Constitution also guarantees important rights that allow people to engage in business activities.

Property Rights

The most important of these is the constitutional recognition of property rights. In many other countries, even in modern times, the king or other ruler has had the power to take people's property for his own use. Early American statesmen wanted to protect against this, so they included property as a protected right under the Fifth Amendment. It is a right just as important as the other individual rights. The Fifth Amendment states that no person shall

> *"be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."*

Since the Fifth Amendment applies only to actions by the federal government, the Fourteenth Amendment, ratified in 1868, also includes a due process clause extending the same limitation to the state governments. These due process clauses prevent the government from taking property away from an individual except when there is a public reason—and even then the government must pay the person the fair value of the property that has been taken. These rights apply to corporations as well, so businesses get the same protection from government seizure that individuals enjoy.

Taxation

The Constitution also contains the basic rules for the ways in which the government can tax individuals and businesses. Congress can only tax in the ways the Constitution allows. Article I gives Congress the power to levy taxes, but Sections 2 and 9 require that direct taxes be apportioned according to population so that everyone will pay the same amount. The Sixteenth Amendment, ratified in 1913, first gave Congress the clear right to set taxes based on income.

Finally, the Constitution guarantees people and businesses the right to make binding contracts. Article I, Section 10 prohibits the states from passing any "Law impairing the Obligation of Contracts." This means that individuals or businesses cannot use the political process to get excused from their contracts. No legislature can pass a law changing the terms of someone's business agreement.

Basic Principles of Free Enterprise

Our free enterprise economy has several key characteristics. These include profit motive, open opportunity, legal equality, private property rights, free contract, voluntary exchange, and competition.

Profit Motive

The American economy rests on a recognition of the importance of the **profit motive**—the force that encourages people and organizations to improve their material well-being. Under other economic systems, the government may control business activities, deciding what companies will be formed and how they will be run. In a free enterprise system, business owners and managers make these choices themselves, operating in ways they believe will maximize their profits. This approach forces management to exercise financial discipline because it makes people economically responsible for their own success or failure. It rewards innovation by letting creative companies grow, and it improves productivity by allowing more efficient companies to make more money.

Open Opportunity

The United States economy also benefits from a strong tradition of **open opportunity**, the concept that everyone can compete in the marketplace. We accept that different people and different companies will have different economic outcomes, depending on their success in the marketplace. This allows economic mobility up or down: no matter how much money you start out with, you can end up wealthier or poorer depending on how well your business performs.

Economic Rights

We also have a commitment to **legal equality**—by giving everyone the same legal rights, we allow everyone to compete in the economic marketplace. Countries that restrict the legal rights of women or minorities lose the productive potential of a large portion of their society. Legal equality maximizes a country's use of its human capital.

Another essential component of the American free enterprise system are **private property rights**, the concept that people have the right and privilege to control their possessions as they wish. The free enterprise system allows people to make their own decisions about their own property.

The right of **free contract** allows people to decide what agreements they want to enter into. The right of **voluntary exchange** allows people to decide what and when they want to buy and sell, rather than forcing them to buy or sell at particular times or at specific prices. Because of all these rights, we have extensive **competition**, the rivalry among sellers to attract customers while lowering costs. Competition provides consumers with the choice of a larger variety of goods, most of which are sold at reasonable prices.

The Role of the Consumer

A fundamental purpose of the free enterprise system is to give consumers the freedom to make their own economic choices. Consumers make their desires known through their economic dealings with producers. When consumers buy

THE WALL STREET JOURNAL.
CLASSROOM EDITION

In the News Read more about basic principles in free enterprise in "Expanding First Amendment," an article in The Wall Street Journal Classroom Edition.

Go Online
The Wall Street Journal Classroom Edition
For: Current Events
Visit: PHSchool.com
Web Code: mnc-1031

profit motive *the force that encourages people and organizations to improve their material well-being*

open opportunity *the concept that everyone can compete in the marketplace*

legal equality *the concept of giving everyone the same legal rights*

private property rights *the concept that people have the right and privilege to control their possessions as they wish*

free contract *the concept that people may decide what agreements they want to enter into*

voluntary exchange *the concept that people may decide what and when they want to buy and sell*

competition *the rivalry among sellers to attract customers while lowering costs*

▲ **From what aspects of the free enterprise system are these students benefiting?**

interest group *a private organization that tries to persuade public officials to act or vote according to group members' interests*

public disclosure laws *laws requiring companies to provide full information about their products*

public interest *the concerns of the public as a whole*

products, they signal to producers what to produce and how much to make.

Consumers can also make their wishes known by joining an **interest group,** which is a private organization that tries to persuade public officials to act or vote according to the interests of the group's members. Interest groups have formed around many economic issues, such as taxation, aid for farmers, and land use.

The Role of the Government

We expect the government to carry out its constitutional responsibilities to protect property rights, contracts, and other business activities in our free enterprise system. Even though such protections are not spelled out in the Constitution, many Americans expect protection from problems that affect us all, such as pollution or unsafe foods.

Information and Free Enterprise

In a free market system, consumer buying habits determine what goods get produced. But consumers will not be able to make informed choices if they cannot get basic information about the products they are buying. In other words, educated consumers will make the free market system work more efficiently. Because of this, one of the government's important roles in the economy is to make sure that producers provide consumers with information.

Consumers use government information to protect themselves from dangerous products and fraudulent claims. **Public disclosure laws** require companies to give consumers important information about their products. Often this information will be attached to the product when it is offered for sale in stores. You may have seen fuel efficiency labels on new cars, or energy efficiency tags on refrigerators or air conditioners. Using this information, consumers can evaluate some important aspects of the products they are considering buying.

Protecting Health, Safety, and Well-Being

Federal and state agencies regulate industries whose goods and services affect the well-being of the public. (See Figure 3.2.) Although the government does not get directly involved in running private businesses, it does impose various restrictions.

Businesses must follow certain environmental protection rules. Gas stations, for example, must dispose of used motor oil properly and ensure that gas tanks cannot leak into surrounding soil. Both individuals and businesses are subject to local zoning laws. These laws may forbid homeowners from running businesses out of their homes.

In addition, until the mid-1900s, manufacturers of cars, food, medicine, and other products affecting people's health and well-being were largely unregulated. Starting in the 1960s, however, the federal government and many states became actively involved in economic matters of **public interest,** the concerns of the public as a whole.

Global Connections

New Business in Russia Starting a new business in Russia is no easy task. The average new business applicant has to deal with 20 to 30 agencies and needs from 50 to as many as 90 approved registration forms. In addition, many businesses have to pay bribes to government officials for start-up licenses. Because the Russian economy is unreliable, banks are reluctant to lend to new businesses. Taxes are often unpredictable and can be very high. There are a vast number of different taxes that apply to almost every aspect of business life, and filling out the tax forms can be time consuming and expensive. As a final roadblock, a few large companies often control virtually an entire industry, making it difficult for new businesses to break in.

A key part of this new government activity was consumer protection. To this end the government sets manufacturing standards, requires that drugs be safe and effective, and supervises the sanitary conditions in which foods are produced. Labels on consumer packages must include information about safe operation of equipment or expiration dates for perishables.

Negative Effects of Regulation

Government regulation, however, can have negative effects on both businesses and consumers. During the 1960s and 1970s, popular demand for government protection of consumers and of the environment resulted in the creation of new governmental agencies and regulations. Businesses pointed out that the rules were costly to implement, cutting into profits, slowing growth, and forcing them to charge unnecessarily high prices. Highly regulated industries, such as the airlines and telephone companies, pointed out that government rules and regulations stifled competition, resulting in prices that were arbitrarily high. The growth in government oversight of industry also raised government spending.

In the 1980s and 1990s, public pressure for leaner, less costly government resulted in budget cuts that curtailed some government regulation of industry. President George W. Bush's administration worked to be more sensitive to the economic considerations raised by businesses.

***Figure 3.2* Major Federal Regulatory Agencies**

Agency and Date Created	Role
1906 Food and Drug Administration (FDA)	Sets and enforces standards for food, drugs, and cosmetic products
1914 Federal Trade Commission (FTC)	Enacts and enforces antitrust laws to protect consumers
1934 Federal Communications Commission (FCC)	Regulates interstate and international communications by radio, television, wire, satellite, and cable
1958 Federal Aviation Administration (FAA)	Regulates civil aviation, air-traffic and piloting standards, and air commerce
1964 Equal Employment Opportunity Commission (EEOC)	Promotes equal job opportunity through enforcement of civil rights laws, education, and other programs
1970 Environmental Protection Agency (EPA)	Enacts policies to protect human health and the natural environment
1970 Occupational Safety and Health Administration (OSHA)	Enacts policies to save lives, prevent injuries, and protect the health of workers
1972 Consumer Product Safety Commission (CPSC)	Enacts policies for reducing risks of harm from consumer products
1974 Nuclear Regulatory Commission (NRC)	Regulates civilian use of nuclear products

BUILDING KEY CONCEPTS

This table shows a few of the many federal regulatory agencies. **Government** **Might the free market fulfill the mission of any of these agencies? Give an example.**

Section 1 Assessment

Progress Monitoring *Online*
For: Self-quiz with vocabulary practice
Web Code: mna-1035

Key Terms and Main Ideas

1. Explain the importance of the following terms in the U.S. free enterprise system: **(a) profit motive, (b) voluntary exchange, (c) private property rights,** and **(d) competition.**
2. What constitutional guarantees underlie the American free enterprise system?
3. Explain at least three benefits of the free enterprise system.

Applying Economic Concepts

4. ***Critical Thinking*** What are some opportunity costs of a greater government role in the economy?
5. ***Decision Making*** Explain how the decisions you make as a consumer influence the economy.
6. ***Critical Thinking*** What is the impact of economic concepts in the U.S. Constitution on contemporary economic issues and policies? Use specific examples from the chapter to support your conclusions.

Go Online
PHSchool.com
For: Critical Thinking Activity
Visit: PHSchool.com
Web Code: mnd-1031

ECONOMIC

Profile

Economist

Entrepreneur

Alice Rivlin (b. 1931)

During the 1994 congressional election campaign, debate raged about how to reduce government spending. Clinton-appointed economist Alice Rivlin recommended controversial cuts in government programs. When the Republicans, who had called for tax cuts instead, gained many seats in the election, the president's political advisors urged that Rivlin be fired.

Principles and Politics

Such controversy was nothing new for Alice Rivlin, who by 1994 had already built a long and distinguished career in Washington. Rivlin's opinions about the role of government in the nation's economy had gained her a reputation as a tough, nonpolitical economic analyst. "I am a fanatical, card-carrying middle-of-the-roader," Rivlin has stated. A former director of the Congressional Budget Office agreed. "She is someone who's called the shots straight," he said.

A Career in Public Service

As a teenager, Alice Rivlin wanted to be a diplomat. After taking an economics course in college, however, she decided on that field instead. Rivlin's talent for analyzing government policy emerged in 1957, when she worked at the Brookings Institution, a Washington "think tank" that researches social issues. In the 1960s, she helped plan President Johnson's "Great Society," a series of government programs aimed at reducing poverty.

In 1975, Rivlin became the first head of the Congressional Budget Office, a federal agency created to help Congress better understand government spending issues. When Bill Clinton became president in 1993, he called Rivlin to serve as Director of the Office of Management and Budget (OMB). In 1996, Clinton appointed her to the Federal Reserve Board, where she served until 1999. Today, Rivlin is chair of the Center on Urban and Metropolitan Policy at the Brookings Institution.

Rethinking Government's Role

Rivlin shuns both direct federal spending and tax policy as ways to stimulate economic growth. Instead, she prefers programs that increase overall productivity. Rivlin also argues that spending on technology, transportation, communications, and education is a better approach to growth than cutting taxes.

Rivlin also questions, in general, the federal government's role in the business sector. She argues that programs to aid business should be at the state level, where a better grasp of specific needs exists. Rivlin favors federal involvement only in areas such as environmental protection, whose effects can be felt across state lines.

CHECK FOR UNDERSTANDING

1. Source Reading In her call for program cuts to reduce government spending, Alice Rivlin wrote: "Everyone looks for ways of accomplishing ambitious goals without effort—lose weight without dieting, learn French while you sleep." Explain what she meant.

2. Critical Thinking Would Alice Rivlin be more likely to favor tax breaks to encourage companies to hire unemployed workers or creating a new government-funded training program to teach workers useful job skills? Explain your answer.

3. Decision Making Do you agree or disagree with Rivlin's opinion that lowering taxes does not effectively raise living standards?

Section 2 Promoting Growth and Stability

Preview

Objectives

After studying this section you will be able to:

1. **Explain** how the government tracks and seeks to influence business cycles.
2. **Analyze** how the government promotes economic strength.
3. **Analyze** the effect of technology on productivity.

Section Focus

The government attempts to stabilize business cycles, aids the growth of the economy, and encourages technological innovation.

Key Terms

macroeconomics
microeconomics
gross domestic product (GDP)
business cycle
work ethic
technology

America's economy is big—very big. It consists of roughly 108 million households of about 288 million people who work at some 137 million jobs and earn more than $8 trillion a year. They make savings deposits of $28 billion or so in about 71,000 banks. They buy close to 6.5 million homes and 17 million automobiles a year.

In Washington, armies of economists use the latest computer and other technologies to try to predict whether this massive economy will grow or shrink. Economic policymakers pull in the reins when the economy bolts at breakneck speed, and attempt to kick start it when it gets slow and unproductive.

Tracking Business Cycles

In this section we'll examine how the United States government affects macroeconomic trends. **Macroeconomics** is the study of the behavior and decision making of entire economies. This branch of economics examines major trends for the economy as a whole. **Microeconomics,** in contrast, is the study of the economic behavior and decision making of small units, such as individuals, families, households, and businesses. (*Macro* means "large," while *micro* means "small.")

One way economists measure economic well-being is by calculating the nation's **gross domestic product (GDP),** the total value of all final goods and services produced in an economy. Economists follow the country's GDP and other key statistics to predict business cycles. A **business cycle** is a period of macroeconomic expansion followed by a period of contraction, or decline. These economic cycles are major fluctuations, unlike the day-to-day ups and downs of the stock market. We are always at some point in the business cycle. Cycles may last less than a year or continue for many years.

Free enterprise systems are subject to business cycles because economic decisions about factors such as prices, production, and consumption are made by individuals and businesses acting in their own self-interest. In America's free enterprise system, the government plays a role in attempting to prevent wild swings in economic behavior.

Where we are in a given business cycle affects our lives every day. If the economy doesn't create enough jobs, high school graduates have trouble finding work. If prices rise, but incomes don't, our ability to buy what we need declines.

Promoting Economic Strength

Because the market is vulnerable to business cycles, the government creates

macroeconomics *the study of the behavior and decision making of entire economies*

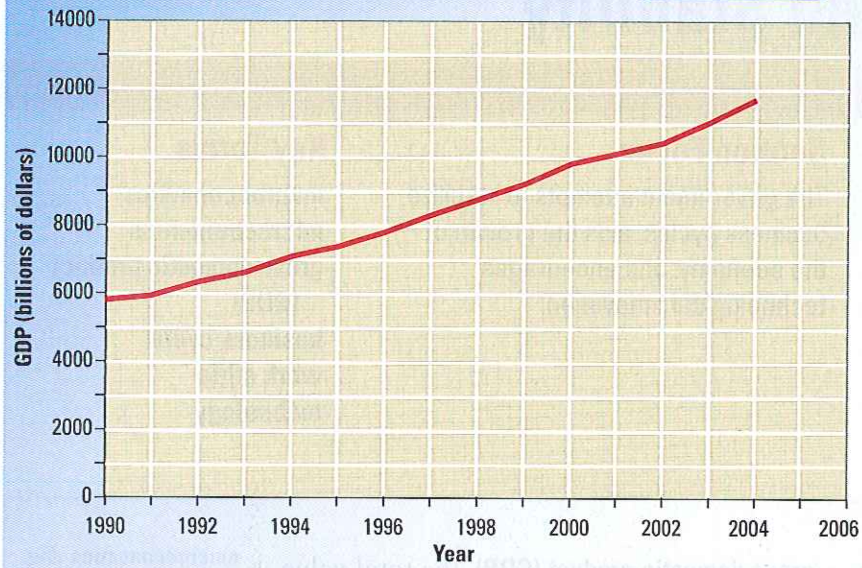
microeconomics *the study of the economic behavior and decision making of small units, such as individuals, families, and businesses*

gross domestic product (GDP) *the total value of all final goods and services produced in a particular economy*

business cycle *a period of macroeconomic expansion followed by a period of contraction*

Figure 3.3 **Gross Domestic Product, 1990–2004**

Go Online
PHSchool.com
Web Code: mng-1032



Source: Bureau of Economic Analysis

BUILDING KEY CONCEPTS U.S. economic growth soared in the 1990s but slowed somewhat in the 2000s. **Economic Systems How does the growth of GDP reflect the strengths of the free enterprise system?**

Slow growth keeps tech in 'stall' mode

Spending, hiring trends reflect broader economy

By Robert Weisman
GLOBE STAFF

High-tech companies have grown accustomed to navigating periods of boom and bust. Now they may have to get used to a less familiar phenomenon: slow growth.

Picking through the mid-summer data, analysts and economists point to several signs that business is picking up for technology companies — higher PC shipments, hiring and research outlays, a bump in IPOs, and some quarterly earnings gains — but few hints of a rebound hardy enough to recall the salad days of the late 1990s.

The tortoise-...

public policies that aim to stabilize the economy. Policymakers pursue three main outcomes as they seek to stabilize the economy: high employment, steady growth, and stable prices.

Employment

One aim of federal economic policy is to provide jobs for everyone who is able to work. In the United States, many economists consider an unemployment rate of between 4 percent and 6 percent to be desirable. In the last half of the twentieth century, the jobless rate ranged between 3 percent and 11 percent.

Growth

Part of the American Dream has always been for each generation to enjoy a higher standard of living than that of previous generations. For each generation to do better, the economy must grow to provide additional goods and services to succeeding generations. GDP is a measure of such growth.

Stability

Another macroeconomic task that the government pursues is keeping the economy stable and secure. Stability gives consumers, producers, and investors confidence in the economy and in our financial institutions, promoting economic freedom and growth.

One indicator of economic stability is general price levels. The government's aim is to help prevent sudden, drastic shifts in prices. A surge in overall prices puts a strain on consumers, especially people on fixed incomes. When prices sink, producers and consumers feel the pain. A jump in the price of milk, for example, is hard on families with children, while a plunge in milk prices hurts dairy farmers. In either direction, major fluctuations in price levels can cause a macroeconomic chain reaction that policymakers seek to avoid.

Another sign of economic stability is the health of the nation's financial institutions. None of us wants to go to the bank and find it boarded up and empty. When we make a bank deposit or a stock purchase, we want to know that our money will be protected from fraud or mismanagement and shielded from the damaging effects of sudden economic downturns.

To provide such assurances, the federal government monitors and regulates American banks and other financial institutions. It produces hundreds of regulations, and it has the power to enforce them.

Federal banking regulations protect bank deposits and retirees' pensions. Federal regulators investigate fraud and manage interest rates and the flow of money through the economy. You'll learn more about these functions in later chapters.

Economic Citizenship

Achieving macroeconomic growth and stability is not easy. Through the way it spends money and influences other macroeconomic factors such as interest rates, the government helps to compensate for the typical swings of the business cycle in our economy.

▲ **The inventions of a single man, Thomas Edison (right), brought a technological revolution to the United States and launched a new era of economic growth. Following that tradition of technological innovation, Charlie Matykiewicz (left) displays his automatic dog washer, a prize winner at an Invention Convention in Philadelphia.**

Do you expect your generation to have a higher standard of living than that of past generations? As a voter, your elective choices will help guide government economic policy. That's why it's more important than ever for American citizens to understand the macroeconomic processes that shape our futures.

Technology and Productivity

The American economy maintains a far higher standard of living, in terms of GDP, than most of the world. You've read that one way to preserve that high standard is by increasing productivity—shifting the production possibilities frontier outward. How do we do that? One way is through the American **work ethic,** a commitment to the value of work and purposeful activity. Another way to increase productivity is through improved technology.

Technological Progress

Technology is the process used to produce a good or service. Improvements in technology allow an economy to produce more output from the same or a smaller quantity of inputs, or resources. Technological progress allows the United States economy to operate more efficiently and productively, increasing GDP and giving U.S. businesses a competitive advantage in the world.

American history is full of innovations that improved productivity. Thomas Edison's invention of the light bulb in 1879 made possible a longer workday. From weaving looms to tractors to computers, machines have allowed us to generate more goods in a shorter amount of time with fewer raw materials.

In addition, although innovation makes some production processes and workers out-of-date, or obsolete, these resources can be used in other ways. For example, old indus-

work ethic *a commitment to the value of work and purposeful activity*

technology *the process used to produce a good or service*

FAST FACT

How can technology help ensure both our energy future and continuing economic growth? Resources that can be tapped today are "known (proven) reserves." Resources that can perhaps be tapped in the future using new technology are "ultimately recoverable reserves." Many scientists believe that we will be able to unlock these vast "ultimately recoverable reserves" as technology continues to improve. In addition, each unit of energy can be made more efficient through expanding technology.

trial buildings can be converted into stores or apartments. Old machines can be recycled and used to produce new machines.

The Government's Role

Inventions are the engine of the free enterprise system. They help us to build "more-better-faster," thus giving consumers more economic choices. Recognizing the need for innovation to maintain America's technological advantage, the government provides incentives for innovation.

Federal agencies fund scores of research and development projects at universities. The Morrill Acts of 1862 and 1890 created so-called land-grant colleges that received federal land and money to pursue the study of "agriculture and the mechanical arts." Land-grant schools from the Massachusetts Institute of Technology to Texas A&M University have been powerhouses of innovation.

The government's own research institutions also produce a steady stream of new technologies that make their way into the marketplace. Probably the best-known example of such an institution is the National Aeronautics and Space Administration (NASA). Technology created by NASA to blast humans into space and to explore distant planets has produced amazing "spinoffs," products with commercial uses. NASA spinoffs include everything from a muscle stimulator for people with paralysis to a scanner that allows firefighters to see "invisible flames" given off by alcohol or hydrogen fires.

The government also plays a role in innovation by offering inventors the possibility of making huge profits in the free market. It does so by granting patents and copyrights.

A U.S. patent gives the inventor of a new product the exclusive right to produce and sell it for 20 years. A copyright grants an author exclusive rights to publish and sell his or her creative works.

The Framers of the Constitution foresaw the economic need to create incentives for innovation. Congressional authority to issue patents and copyrights is stated in Article 1, Section 8 of the Constitution. It gives Congress the power to "promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."

Section 2 Assessment

Progress Monitoring *Online*
For: Self-quiz with vocabulary practice
Web Code: mna-1036

Key Terms and Main Ideas

1. Compare **macroeconomics** with **microeconomics**, and give an example of each.
2. How does **gross domestic product (GDP)** provide a means to analyze economic growth?
3. What does GDP tell economists about **business cycles?**
4. Give one example of a new **technology** that has resulted in greater productivity for the United States.
5. (a) How do patents and copyrights promote innovation? (b) How does innovation help the economy?
6. Describe and analyze how economic stability is measured.

Applying Economic Concepts

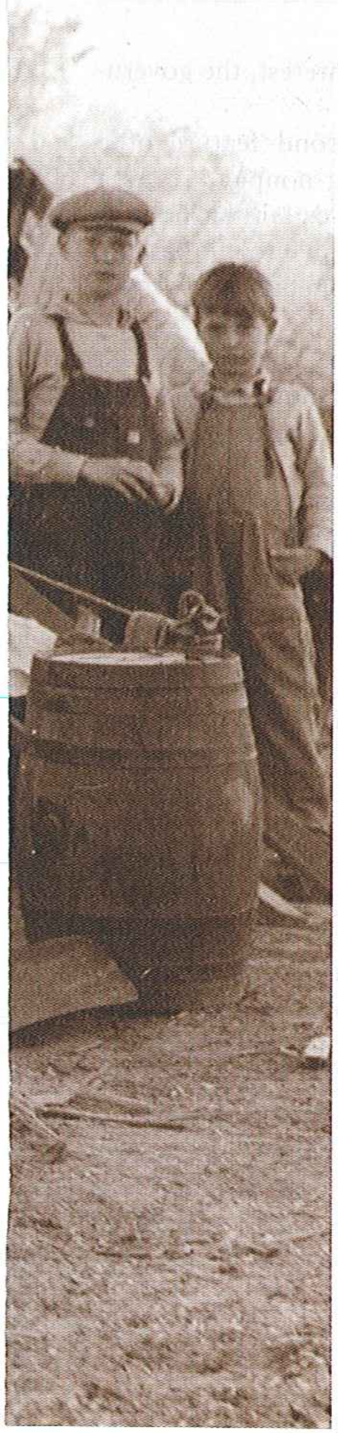
7. ***Decision Making*** Are the macroeconomic goals of employment, growth, and stability best met by the public sector or by the private sector? Explain.
8. ***Critical Thinking*** Explain how scientific discoveries and technological innovations create the need for rules and regulations to protect individuals and businesses.

Go Online
PHSchool.com
For: Research Activity
Visit: PHSchool.com
Web Code: mnd-1032

Skills for
LIFE

Analyzing Primary Sources

A primary source is information produced during or soon after an event, usually by a participant or observer. Although primary sources can convey a strong sense of an event or historical period, they may be inaccurate or biased. For that reason, you must analyze primary sources critically. Read the passage below, written during the early 1930s, and then practice analyzing primary sources by following these steps.



1. **Identify the document.** Read the passage for tone and authorship. (a) What sort of document is this? (b) Who is the author? How can you tell?

2. **Interpret the contents of the document.** Compare the details of this document to what you already know about the Great Depression. (a) How did the family live before the Depression? (b) How did the Depression affect the family?

3. **Analyze the document.** Read critically to determine the importance of the selection. (a) What do you think the purpose of the story was when it was published in 1934? (b) Is this story consistent with the economic statistics below?

A Boy Tramp Tells of the "Big Trouble"

But we got along swell before the big trouble came even if there were seven of us kids. I shined shoes in a barber shop. Jim carried papers. And Marie took care of Mrs. Rolph's kids. Mother always did some sewing for the neighbors. We had a Chevvie and a radio and a piano. I even started to high school mornings, the year the big trouble came...

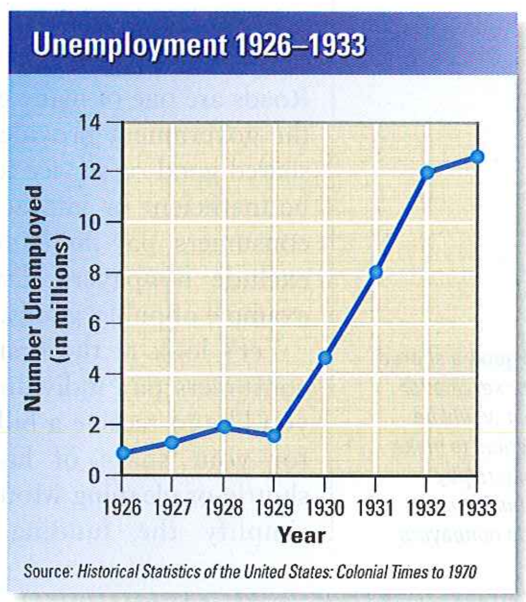
Dad got sick as usual but we never thought anything of it. When he comes to go back to work he can't get a job, and everybody all of a sudden-like seems to be hard up. I cut the price of shines to a nickel, but it didn't help much...

Mrs. Rolph's husband got a cut and she cans Marie. Jim had to quit the paper route because he lost all his cash customers, and the others never paid. Nobody wanted Mother to sew anything.

Source: Thomas Minehan, *Boy and Girl Tramps of America,* (New York: Holt, Rinehart & Winston, Inc., 1934).

Additional Practice

Find a primary source document that concerns unemployment in a different period of the history of the United States. What similarities and differences do you notice?



Section 3 Providing Public Goods

Preview

Objectives

After studying this section you will be able to:

1. **Identify** examples of public goods.
2. **Analyze** market failures.
3. **Evaluate** how the government allocates some resources by managing externalities.

Section Focus

The government sometimes steps in to provide a shared good or resource when it would be impractical for consumers to pay individually.

Key Terms

public good
public sector
private sector
free rider
market failure
externality

What if the government decided to leave the business of road-building up to private citizens? If you wanted a road in front of your house, you'd have to pay a contractor to build it. Or more likely, you and your neighbors could chip in and hire someone to build you a small network of streets.

What problems might arise in this scenario? For one thing, if groups of individuals pooled their money to build a road or a freeway, who would they allow to use it? Would drivers have to constantly stop and pay the owners of each road they drove on? How would individuals living in sparsely populated areas come up with enough money to build the roads they needed?

Public Goods

Roads are one of many examples in which the government provides a **public good,** a shared good or service for which it would be inefficient or impractical (1) to make consumers pay individually and (2) to exclude nonpayers. Dams are another example of public goods.

public good *a shared good or service for which it would be impractical to make consumers pay individually and to exclude nonpayers*

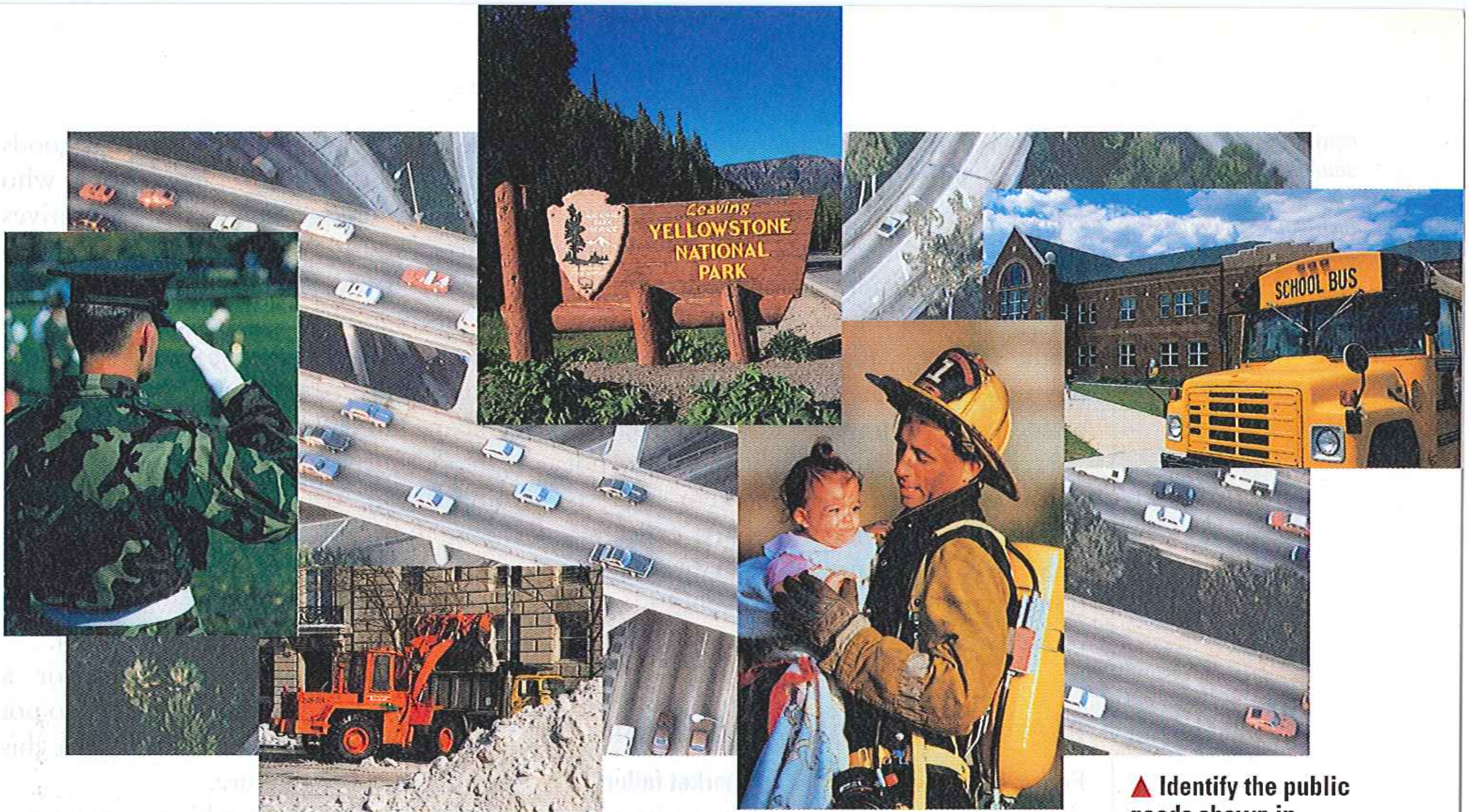
Let's look at the first feature, making consumers pay individually: How would you like to receive a bill in your mailbox for your share of launching a space shuttle or cleaning Mount Rushmore? To simplify the funding of government projects in the public interest, the government collects taxes.

What about the second feature of a public good, excluding nonpayers? As a society, we believe that certain facilities or services should be available to all. Besides, excluding nonpayers from highways would be a nightmare.

Most goods are public simply because a private provider could not charge those who benefit or exclude nonpayers from benefiting. For example, in 1872, Congress created the nation's first national park, Yellowstone. The national park system ensured that the natural resources Americans value would be protected.

If a park were privately owned, the owner could charge an admission fee. Yet some benefits generated by the park, such as the preservation of wildlife, would be enjoyed by nonpayers as well as payers. The owner could neither charge people for that public benefit nor exclude them from it.

Public goods have other characteristics: Any number of consumers can use them without reducing the benefits to any single consumer. For the most part, increasing the number of consumers does not increase the cost of providing the public good. So if you're driving on a highway and eight other drivers come along, they do not significantly reduce the road's benefits to



▲ **Identify the public goods shown in these photos.**

you or increase the government's cost of providing it.

Costs and Benefits

As you read in Section 1, the federal government steps in to act in the public interest whenever it determines that the benefits of a policy outweigh the drawbacks. In road construction, the advantages are obvious. The drawback is the economic freedom we give up, since none of us individually gets to decide what roads will be built, and where. Still, in this example the advantages of public road construction outweigh the drawback. In other cases, weighing benefits against costs is more complicated and open to debate.

Cost is critical in determining whether something gets produced as a public good. When a good or service is public,

1. the benefit to each individual is less than the cost that each would have to pay if it were provided privately, and
2. the total benefits to society are greater than the total cost.

In such circumstances, the market would not provide the good; the government would have to, or else it wouldn't get done. Study carefully Figure 3.4 on the next page. Does the dam-building project meet the two criteria for a public good?

Public goods are financed by the **public sector,** the part of the economy that involves the transactions of the government. The **private sector,** the part of the economy that involves transactions of individuals and businesses, would have little incentive to produce public goods.

Free-Rider Problem

A phenomenon associated with public goods is called the "free-rider problem." A **free rider** is someone who would not choose to pay for a certain good or service, but would get the benefits of it anyway if it were provided as a public good.

Would you voluntarily contribute, say, $3,500 to buy army helmets—your portion of America's military cost this year? Perhaps not. Yet when the government provides a system of national defense, you benefit, whether you pay or not.

Try another example: Everyone on your street wants fire protection except one penny-pinching neighbor, who says it's not worth the money. Do you want him to have fire protection anyway? Yes. If his

public sector *the part of the economy that involves the transactions of the government*

private sector *the part of the economy that involves the transactions of individuals and businesses*

free rider *someone who would not choose to pay for a certain good or service, but who would get the benefits of it anyway if it were provided as a public good*

market failure *a situation in which the market does not distribute resources efficiently*

house catches fire, yours could ignite as well. So local taxes pay for firefighting services for all property in a given area, because all residents are better off if the government provides this service.

Returning to the example of roads, you might not be willing to pay for a new freeway in your area. But if it is built, you would use it. You would be a free rider.

Free riders consume what they do not pay for. The free-rider problem suggests that if the government stopped collecting taxes and relied on voluntary contributions, many public services would have to be eliminated.

Market Failures

Free riders are examples of **market failure,** a situation in which the market, on its own, does not distribute resources efficiently. To understand market failure, recall how a successful free market operates: Choices made by individuals determine what goods get made, how they get made, and who consumes the goods. Profit incentives attract producers, who, because of competition, provide goods and services that consumers need at a price they can afford.

In the road-building scenario, are these features of a free market present? No. If a company did build a road, it could charge a high price for tolls because it would have no competition. Also, companies would not choose to build roads in sparsely populated areas because profit incentives in those areas might be non-existing. This way of getting roads built would be highly impractical.

In this scenario, the criteria for a properly functioning market system do not exist. That's why economists consider this situation a market failure.

Note that public ownership can sometimes produce negative externalities, however. Some public lands, for example, might be more usefully managed if owned privately.

BUILDING KEY CONCEPTS

This diagram shows the process that determines whether a public good will be generated. **Opportunity Costs** **If the farmers also wanted irrigation ditches built to carry the lake water to their fields, would the ditches be built as a public good? Explain.**

Figure 3.5 **The Creation of a Public Good**

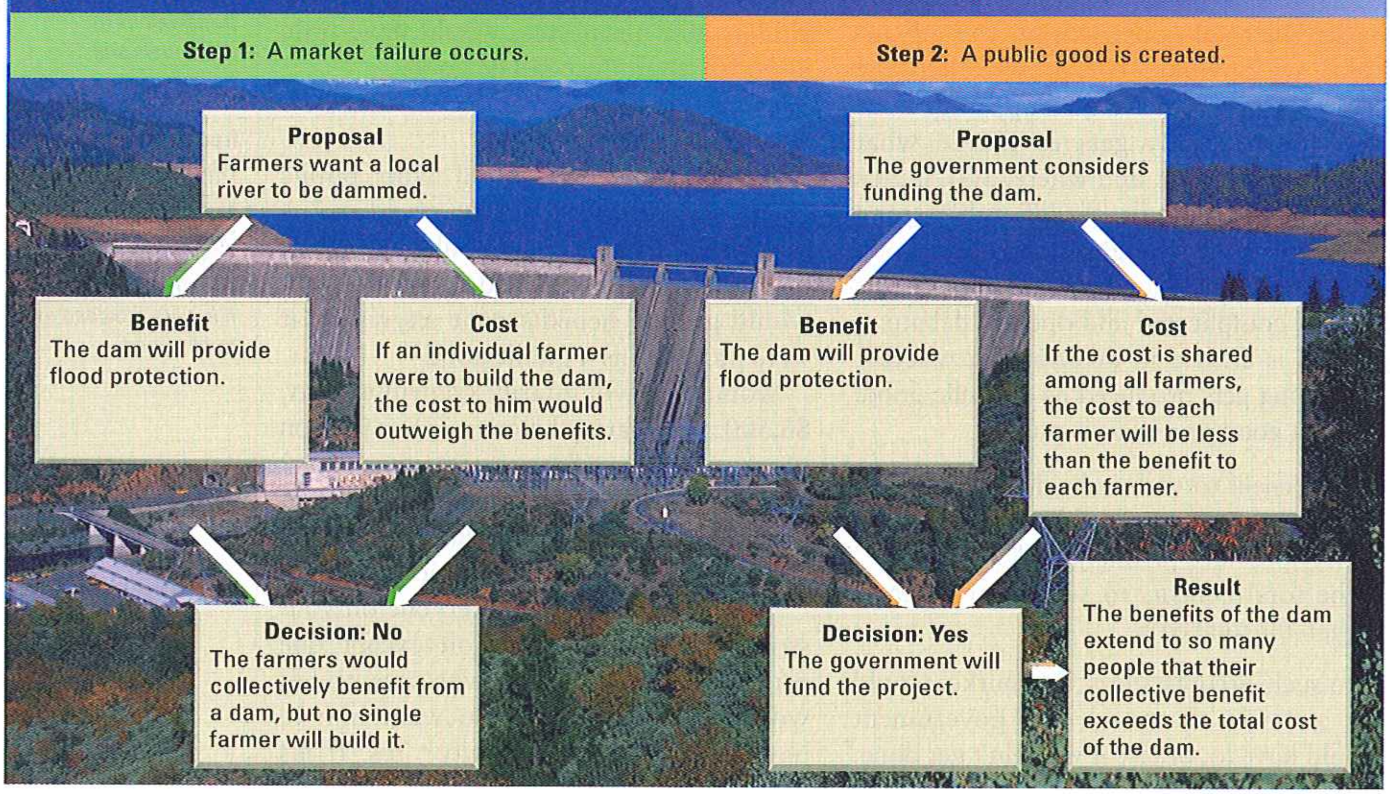
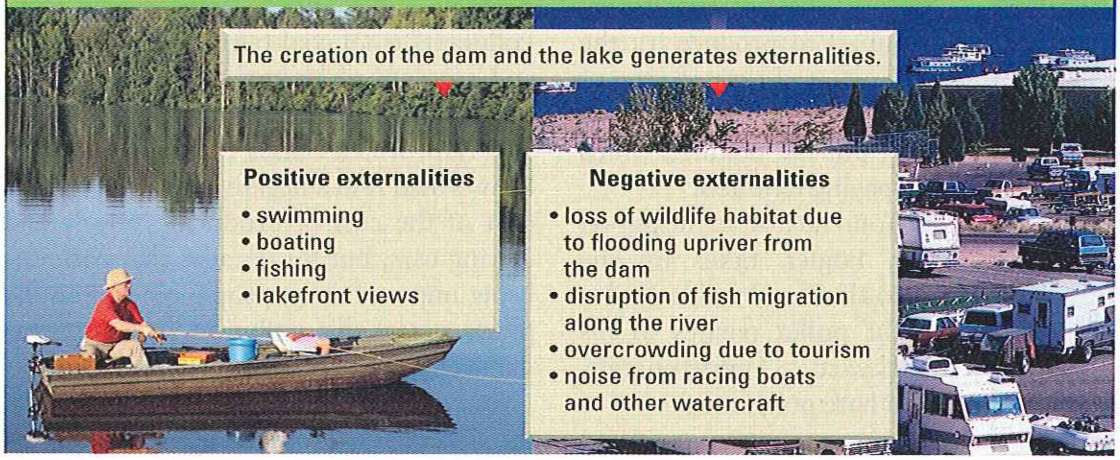


Figure 3.6 Positive and Negative Externalities

Step 3: Externalities result.



Construction of a new dam creates dozens of externalities, positive and negative, depending on your point of view. **Public Policy** **What groups of people might feel the greatest economic impact from the new dam?**

Externalities

All of the previous examples involve side effects of some sort. They illustrate what economists call externalities. An **externality** is an economic side effect of a good or service that generates benefits or costs to someone other than the person deciding how much to produce or consume. Externalities can be positive or negative, as follows.

externality *an economic side effect of a good or service that generates benefits or costs to someone other than the person deciding how much to produce or consume*

Positive Externalities

We've said that public goods generate benefits to many people, not just those who pay for the goods. Such beneficial side effects are called *positive externalities.*

The private sector can create positive externalities, too. In fact, many experts believe that the private sector generates positive externalities more efficiently than the public sector can, and at less cost to taxpayers. For instance:

- Dynamo Computers hires underprivileged teenagers and trains them to be computer programmers. Those workers are then available to be hired by other companies, who benefit from the workers' skills without having paid for them.
- Mrs. Garland buys an old house that is an eyesore in the neighborhood. She paints the house, cuts the grass, and plants flowers. Her neighbors were not involved in her economic decision. But they receive benefits from it, such as higher property values and a better view.

Whether private or public, positive externalities cause part of the benefit of a good to be gained by someone who did not purchase it. In the 1990s, several endangered species, including the bald eagle and the peregrine falcon, were saved from extinction. Protection of species critical to our ecosystem benefits us all.

Negative Externalities

Of course, some decisions to produce goods and services generate unintended costs, called *negative externalities.* Negative externalities cause part of the cost of producing a good or service to be paid for by someone other than the producer. For example:

- The Enchanted Forest Paper Mill dumps chemical wastes into a nearby river, making it unsafe for swimming. The downstream city of Tidyville is forced to install special equipment at its water-treatment plant to clean up the mess. If the treatment cost is $20 per ton of paper

FAST FACT

"Pollution permits" issued by the government can be used to limit the negative externalities of industrial production. Each permit allows a firm such as a paper mill to produce a certain amount of a given pollutant in a given time period. As long as the total amount of the pollutant remains within government limits, the mills may buy and sell permits among themselves. Some firms may make enough money from selling permits to offset the cost of extra reductions in waste. Over time, the paper industry will achieve the same reduction in waste at a lower cost per gallon.

produced, and the mill's production cost is $100 (the cost of all the materials, labor, and machinery required to produce it), the full, or social, cost of a ton of paper is $120. The community, not the polluter, winds up paying that $20.

- Your next-door neighbor, Mr. Fogler, takes up the accordion and holds Friday night polka parties in his backyard. Unfortunately, you hate polka music.

Government's Goals

When externalities are present, we have a market failure, because the costs or benefits of a good or service are not assigned properly. Understanding externalities helps us see how the government functions in the American economy.

First, the government encourages the creation of positive externalities. Education, for example, benefits students, yet society as a whole also benefits from an educated population. This is because educated workers are generally more productive.

Next, the government aims to limit negative externalities, such as acid rain. Pollutants from coal-burning power plants and auto emissions can drift high into the atmosphere and come down in the form of acid rain, which causes ecological damage. Why is acid rain a negative externality? It is part of the cost of producing power and driving cars, but for decades that cost was being imposed upon people other than the producers of this pollution. The cost was damaged trees, lakes, and wildlife.

To help address this negative externality, the federal government now requires all new cars to have an expensive antipollution device called a catalytic converter. In addition, the Environmental Protection Agency offers incentives to power-plant operators to put "scrubbers" on their smokestacks to cut emissions. These actions transfer the costs of pollution back to its producers.

See the Fast Fact on this page for an explanation of pollution permits. These are another way to help eliminate this negative externality.

Section 3 Assessment

Progress Monitoring *Online*
For: Self-quiz with vocabulary practice
Web Code: mna-1037

Key Terms and Main Ideas

1. Explain this sentence: Most **public goods** generate positive **externalities.**
2. Why is a **free rider** a type of **market failure?**
3. What is the difference between the **public sector** and the **private sector?** Give examples of each.

Applying Economic Concepts

4. ***Critical Thinking*** How does the government attempt to encourage positive externalities and limit negative externalities? Give two examples of each.
5. ***Critical Thinking*** Is the criminal justice system (police and the courts) a public good? Explain.
6. ***Decision Making*** A city has a shortage of parking spaces near downtown businesses. Should the city build a new parking garage or leave it to the private sector? Explain your reasoning.
7. ***Problem Solving*** Explain why this statement is true or false: *Government steps in to allocate resources efficiently so that the country is operating on its production possibilities curve instead of under it.*

Go Online
PHSchool.com
For: Research Activity
Visit: PHSchool.com
Web Code: mnd-1033

Section 4 Providing a Safety Net

Preview

Objectives

After studying this section you will be able to:

1. **Summarize** the U.S. political debate on ways to fight poverty.
2. **Describe** the main programs through which the government redistributes income.

Section Focus

Sometimes the United States government has to step in to create programs to aid poor, disabled, and elderly people.

Key Terms

poverty threshold
welfare
cash transfers
in-kind benefits

Prosperity is a hazy memory in East St. Louis. Tumble-down buildings and weed-covered lots scar the urban landscape. Poverty and unemployment are constant companions in this Illinois city of 40,000 or so residents.

The city hugs the banks of the Mississippi River across from its prosperous big brother, St. Louis, Missouri, a city of more than 330,000 people. At one time, both cities profited from their locations on the busy river. But in the 1970s the firms of East St. Louis packed up and fled, having found better business opportunities elsewhere. With few businesses to tax and a jobless population, the city edged toward bankruptcy, unable to provide even the most basic services, like garbage collection and police and fire protection. At the end of the twentieth century, while much of the United States enjoyed economic growth, East St. Louis struggled merely to exist.

The Poverty Problem

While the free market has proven better at generating wealth than has any other economic system, that wealth is spread unevenly throughout society. This leaves some people below the **poverty threshold,** an income level below that which is needed to support families or households. The poverty threshold is a relative figure determined by the federal government and adjusted periodically. In 2004, the poverty threshold for a single parent under age 65, with one child, was $12,490. For a four-person family with two children, it was $18,850. In East St. Louis, 42 percent of families with children live below the poverty line. The median household income is about $25,000 a year.

poverty threshold *an income level below that which is needed to support families or households*

The Government's Role

The opportunities that the free market offers can lift the working poor into the middle class. Yet, in poor areas from East St. Louis to rural Appalachia to south-central Los

▲ Members of the East St. Louis Action Research Project, founded in 1990, help rehabilitate an economically depressed neighborhood.

welfare *government aid to the poor*

Angeles, economic opportunities are limited because of factors such as a lack of local jobs and few educational opportunities.

As a society, we recognize some responsibilities to the very young, the very old, the sick, the poor, and the disabled. For these people, the government tries to provide a safety net. Various federal, state, and local government programs help to raise people's standard of living, their level of economic well-being as measured by the ability to purchase the goods and services they need and want.

Yet, in a society that prefers limited government activity in the economy, poverty poses tough questions: What can the government do to combat poverty? What should it do? Is government regulation the best way to help the poor?

The Welfare System

Since the 1930s, the main government effort to ease poverty has been to collect taxes from individuals and redistribute some of those funds in the form of welfare. **Welfare** is a general term that refers to government aid for the poor. It includes many types of redistribution programs.

The nation's welfare system began under President Franklin Delano Roosevelt, following the Great Depression. Welfare spending increased considerably in the 1960s under President Lyndon B. Johnson's "War on Poverty."

Welfare payments soared in the 1970s and 1980s. In the 1990s, critics of welfare voiced increasing concern about people becoming dependent on welfare and being unable or unwilling to get off it. Some also pointed out that income redistribution discourages productivity, thus actually aggravating poverty. In 1996, Congress made sweeping changes in the welfare system.

Redistribution Programs

Income data are gathered by the U.S. Bureau of the Census, an agency within the Labor Department. The Census Bureau conducts monthly surveys of households to track key economic data. Using the data, the Census Bureau estimates how many people are living in poverty.

Chapter 13 will treat the causes of poverty in detail. In the meantime, here is an overview of the major types of redistribution programs through which the federal government helps the poor and the elderly.

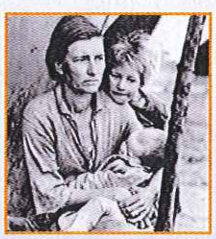
BUILDING KEY CONCEPTS

Throughout the 1900s, federal spending on social programs grew to include more and more people in need.

Opportunity Costs

What are some of the trade-offs involved in spending on social programs?

Figure 3.6 **A Century of Federal Programs to Help Those in Need**



1932 Roosevelt's New Deal begins

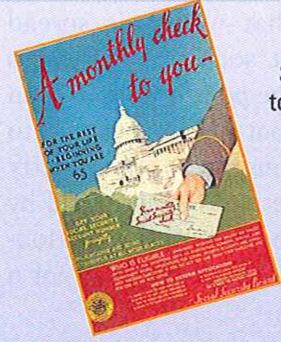
1935 Congress creates Social Security, Aid to Dependent Children (ADC), and unemployment compensation

1948 Truman's Fair Deal begins

1910 | 1920 | 1930 | 1940 | 1950

1916 Kern-McGillicuddy Act establishes workers' compensation for federal employees

1933 Federal Emergency Relief Administration (FERA) founded



1950 Social Security extended to 10.5 million more recipients; ADC becomes AFDC (Aid to Families with Dependent Children)

Cash Transfers

State and federal governments provide **cash transfers,** direct payments of money to poor, disabled, and retired people. The following programs distribute direct cash transfers:

1. *Temporary Assistance for Needy Families* (TANF) This program grew out of the 1990s debate about how to ease poverty while decreasing government payments to the poor. TANF replaced the earlier welfare program, Aid to Families with Dependent Children (AFDC). Critics of AFDC said that it made people dependent on welfare and did not encourage them to take responsibility for their lives.

   Launched in 1996 as part of comprehensive welfare reform, TANF discontinues direct federal welfare payments to recipients. Instead, federal money goes to the states, which design and run their own welfare programs. States must adhere to federal rules that create work incentives and establish a lifetime limit for benefits. The program aims to move people from welfare dependence to the work force.
2. *Social Security* The Social Security program was created in 1935, during the Great Depression, when many of the elderly lost their life savings and had no new income. Social Security provides cash transfers of retirement income to the elderly and living expenses to disabled Americans. The program collects payroll taxes from current workers and then redistributes that money to current recipients.
3. *Unemployment insurance* Another cash transfer is the unemployment insurance program, which is funded jointly by federal and state governments. Unemployment compensation checks provide money to eligible workers who have lost their jobs. Workers must show that they have made efforts to get work during each week that they receive benefits.
4. *Workers' compensation* This program provides a cash transfer of state funds to workers injured on the job. Most employers must pay workers' compensation insurance to cover any future claims their employees might make. This insurance has become more and more expensive as medical expenses and the number of reported on-the-job injuries have increased.

THE WALL STREET JOURNAL.
CLASSROOM EDITION

In the News Read more about income redistribution in "Low-Income, Low Tech," an article in The Wall Street Journal Classroom Edition.

Go Online
The Wall Street Journal Classroom Edition
For: Current Events
Visit: PHSchool.com
Web Code: mnc-1034

cash transfers *direct payments of money to eligible poor people*

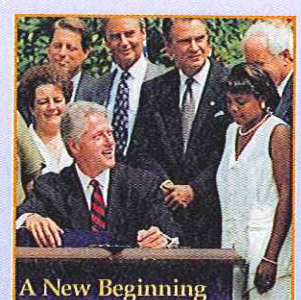
1965 Medical Care Act creates Medicare (for retirees and the disabled) and Medicaid (for the poor)

1974 Food Stamp program extended nationwide

2001 President Bush establishes White House Office of Faith-Based and Community Initiatives

1960 1970 1980 1990 2000

1964 Johnson's Great Society program expands welfare with new programs such as Head Start preschool education



1996 AFDC changed to Temporary Assistance for Needy Families (TANF)

In-Kind Benefits

The government also provides poor people with **in-kind benefits,** goods and services provided for free or at greatly reduced prices. The most common in-kind benefits include food giveaways, food stamps, subsidized housing, and legal aid.

Medical Benefits

Another social service that the U.S. government provides is health insurance for the elderly, the disabled, and the poor. Medicare covers Americans over age 65 as well as the disabled. Medicaid covers some poor people who are unemployed or not covered by their employer's insurance plans. Administered under the Social Security program, Medicare and Medicaid are enormously expensive programs. We will examine them further in Chapter 14.

Education

Federal, state, and local governments all provide educational opportunities to the poor. The federal government funds programs from preschool to college. State and local programs aid students with learning disabilities.

Education programs add to the nation's human capital and labor productivity. As you saw in Chapter 1, improved education and technology can make an entire economy more productive by shifting the production possibilities frontier outward.

in-kind benefits *goods and services provided for free or at greatly reduced prices*

Faith-Based Initiatives

In 2001, President George W. Bush announced an initiative to rely on non-governmental support for people in need. His administration "will look first to faith-based organizations, charities, and community groups that have shown the ability to save and change lives."

The President believes that religious organizations have frequently been among the most successful groups delivering social services. These groups not only spend money to solve problems, but also provide a special compassion. He therefore proposed as a next step in welfare reform that faith-based organizations be allowed to compete for federal funds. In 2003, both houses of Congress passed bills enacting some of President Bush's proposals.

Mr. Bush established an Office of Faith-Based and Community Initiatives to help faith-based groups work more effectively with the federal government. He also encouraged the states to create state offices of faith-based action.

Section 4 Assessment

Progress Monitoring *Online*
For: Self-quiz with vocabulary practice
Web Code: mna-1038

Key Terms and Main Ideas

1. How does **welfare** attempt to raise poor people's standard of living?
2. Why does poverty exist in a free market economy?
3. What is the difference between **cash transfers** and **in-kind benefits?**
4. How is Social Security an example of income redistribution?

Applying Economic Concepts

5. ***Math Practice*** Assume that the poverty threshold is $8,980 for an individual and $12,120 for a two-person household. Based on a 40-hour work week, how much would you need to earn per hour in order to be above the poverty threshold for **(a)** an individual and **(b)** a two-person household?
6. ***Critical Thinking*** An old adage states, "Give a person a fish, feed him for a day; teach a person how to fish, feed him for a lifetime." Do any of the government programs in this section reflect this saying? Explain your answer.

Go Online
PHSchool.com
For: Decision-making Activity
Visit: PHSchool.com
Web Code: mnd-1034

Real-life Case Study

Government and the Interstate Highway System

The United States did not always have a good network of roads. In the 19th century, when horse-drawn vehicles were dominant, almost all roads were unpaved. Many became rutted and uneven, making travel difficult, slow, and uncomfortable. The push to build a network of smoother roads began in the 1880s—through the efforts of a bicycle club.

▲ President Dwight Eisenhower signed the Federal Aid-Highway Act on June 29, 1956.

Early Efforts In 1886, a bicycling craze was sweeping the nation. Many American cyclists belonged to the League of American Wheelmen, an organization that wanted smoother roads for cycling. This club was the first to convince Congress to consider building a national highway system. As motor vehicles later became more common, automobile manufacturers, road builders, and gasoline companies took up the crusade for better roads.

State Highways By the early 1900s, Congress began to provide funding to the states to build highways. Each state, however, focused on building highways within its own borders with its own numbering and sign systems—and the highways did not always connect at state borders.

Federal Highways In 1921, the Federal Highway Act got the U.S. government directly involved in highway construction by setting up a system of major highways that connected from state to state, so that drivers could travel between states without ever having to leave a high-speed highway. The government then created a simple system of numbering and marking these interstate highways, to make navigating the system easy. In the 1950s, the Cold War raised concerns about the military's ability to defend the country with existing roads. In 1956, the Federal Aid-Highway Act authorized the construction of 41,000 miles of highways to tie the nation together, creating the interstate highway system we know today.

Today, America's interstate highway system is one of the most important features of the country's infrastructure. It allows people and goods to travel quickly from one part of the country to another, reducing transportation costs and speeding up commerce.

Applying Economic Ideas

1. Why was it inefficient to leave highway construction to individual states?
2. Why do you think it took Congress so long to authorize funds for highway construction?

Chapter 3 Assessment

Chapter Summary

A summary of major ideas in Chapter 3 appears below. See also the **Guide to the Essentials of Economics**, which provides additional review and test practice of key concepts in Chapter 3.

Section 1 Benefits of Free Enterprise (pp. 51–55)

The benefits of the American free enterprise system are the result of the basic principles of **profit motive, voluntary exchange, private property rights,** and **competition.** These benefits include individual freedom for consumers and producers and a wide variety of goods. To protect economic freedoms, the government intervenes in matters of **public interest.** Federal agencies monitor and regulate certain types of businesses. **Public disclosure laws** provide critical information to consumers.

Section 2 Promoting Growth and Stability (pp. 57–60)

Macroeconomics concerns the behavior of whole economies, while **microeconomics** concerns the behavior of smaller economic units, such as households. When necessary, the government takes action to influence macroeconomic **business cycles.** It aids the growth of the economy, as measured by **GDP.** It encourages the creation of new **technologies** by giving patents and copyrights to entrepreneurs.

Section 3 Providing Public Goods (pp. 62–66)

The government provides **public goods,** such as roads, when it would be impractical for individuals to pay for them. Providing public goods produces positive and negative **externalities.**

Section 4 Providing a Safety Net (pp. 67–70)

The government uses tax money to raise the standard of living of people in **poverty.** The nation's welfare system includes programs that distribute various benefits, including **cash transfers, in-kind payments,** and medical benefits.

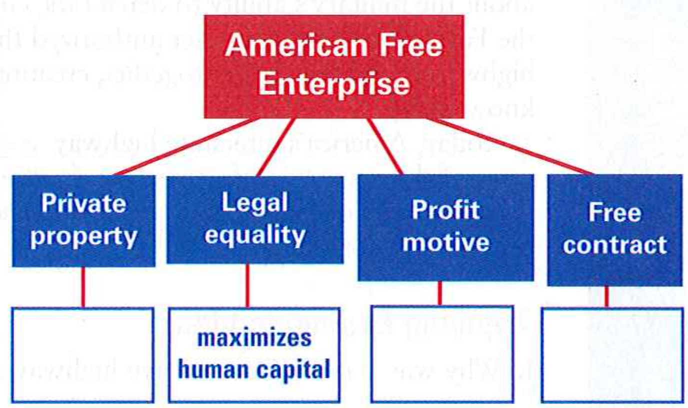
Key Terms

Choose the italicized word in parentheses that best completes each sentence.

1. Acid rain is an example of a(n) *(externality/free rider)*.
2. The tradition of *(private property/open opportunity)* allows everyone to compete in the free market.
3. The right of *(free contract/voluntary exhange)* allows people to decide what agreements they want to enter into.
4. Someone who benefits from a good without paying for it is an example of a *(free rider/public good)*.
5. Food stamps are an example of a/an *(cash transfer/in-kind payment)*.
6. We can use figures on *(gross domestic product/public goods)* to measure economic growth.
7. Study of the behavior of the entire U.S. economy is an example of *(macroeconomics/microeconomics)*.

Using Graphic Organizers

8. On a separate sheet of paper, copy the tree map below to help you organize information about the American free enterprise system. Complete the tree map by writing descriptions and examples for each of the headings shown. You may add branches to the tree.



Reviewing Main Ideas

9. **(a)** How does the government support free enterprise and protect public interest? **(b)** Describe and evaluate the government rules and regulations described in this chapter.
10. Explain the basic principles of free enterprise in your own words.
11. Why does the U.S. government track and influence business cycles?
12. Explain why each of the following is either a cash transfer or an in-kind payment. **(a)** unemployment insurance **(b)** Social Security **(c)** food stamps

Critical Thinking

13. **Drawing Inferences** Choose one of the federal agencies mentioned in Section 1, and explain how it acts to limit negative externalities.
14. **Synthesizing Information** Based on your reading of the chapter, write a paragraph in which you describe and analyze the economic rights of businesses.
15. **Predicting Consequences** How might the invention of a new, powerful fuel source for cars and trucks affect the country's production possibilities frontier? How might the new fuel affect GDP?

Problem-Solving Activity

16. Suppose that there is a three-person city. The three residents are considering having a fireworks display. Gabriela is willing to contribute \$100 toward the display, while Jerome is willing to pay \$80, and Katelyn is willing to pay \$60. The fireworks display costs \$120. (a) Will any single citizen alone be willing to pay for the fireworks? (b) What recommendation can you make to this city that will benefit all three citizens?

Economics Journal

Brainstorming Reread your Economics Journal entry for Chapter 3. Of the benefits of free enterprise that you listed, which are most important to you and your family?

Skills for Life

Analyzing Primary Sources Review the steps shown on page 61; then read the primary source below and answer the following questions.

17. What course of action is President Johnson suggesting in this speech?
18. In your own words, state three economic reasons Johnson uses to support his argument.
19. For what type of assignment might you use this primary source quotation? Explain.

> The war on poverty is not a struggle simply to support people, to make them dependent on the generosity of others. It is a struggle to give people a chance. . . . We do this, first of all, because it is right that we should. . . . We do it also because helping some will increase the prosperity of all. Our fight against poverty will be an investment in the most valuable of our resources—the skills and strength of our people. And in the future, as in the past, this investment will return its cost many fold to our entire economy.
>
> If we can raise the annual earnings of 10 million among the poor by only \$1,000 we will have added \$14 billion a year to our national output. In addition we can make important reductions in public assistance payments which now cost us \$4 billion a year, and in the large costs of fighting crime and delinquency, disease and hunger. . . .
>
> This is only part of the story. Our history has proved that each time we broaden the base of abundance, giving more people the chance to produce and consume, we create new industry, higher production, increased earnings and better income for all.
>
> —President Lyndon B. Johnson, *Public Papers of the Presidents of the United States,* 1965

Progress Monitoring *Online*

For: Chapter 3 Self-Test Visit: PHSchool.com
Web Code: mna-1031

As a final review, take the Economics Chapter 3 Self-Test and receive immediate feedback on your answers. The test consists of 20 multiple-choice questions designed to test your understanding of the chapter content.

THE WALL STREET JOURNAL.

CLASSROOM EDITION

DEBATING CURRENT ISSUES: *Health-Care Costs*

As health-care costs have skyrocketed in recent years, both patients and caregivers have had to ask a difficult question: Should cost be a deciding factor in medical treatment? In this debate from *The Wall Street Journal Classroom Edition*, Abbie Leibowitz, an executive at Health Advocate and former chief medical officer at Aetna, and Dr. David Rogers, a physician in private practice, discuss the role of costs in the health-care system.

YES *Should doctors consider cost when treating a patient?*

BY ABBIE LEIBOWITZ

It is absolutely reasonable and ethical for physicians to consider the costs of care when evaluating treatment options.

The principle of "first do no harm" that all doctors are taught has broader implications than just its application to the patient. Do no harm in your treatment of the patient for the patient's sake, do no harm in treating your patient from a public-health perspective, and do no harm to the system of health care we all depend upon.

As a percentage of our gross domestic product, the U.S. has the most expensive health-care system in the world. Medical-insurance premiums in the private sector have been increasing far faster than the pace of general inflation. They are projected to double between 2003 and 2012 to $3.1 trillion or 17.7% of the nation's GDP. Such increases are unsustainable and are a prescription for an economic and public-health disaster.

As costs increase, payors—whether the government or employers—shift more financial responsibility to the individual in the form of diminished benefits or increasing co-payments and deductibles. The increasing burden of paying for otherwise uncompensated care is like a hidden tax on those who pay for medical services. Providers simply build these costs into the rates they charge those who pay.

Is it good care to so burden a patient with expenses that could have been avoided? Is it good care to prescribe an expensive brand-name product when there is an equally effective generic equivalent that costs less than half as much? If because they cannot afford the cost of care or medicine, patients do not get their prescriptions filled, have we helped them? We have no choice but to exert a conscious control over medical costs.

Resources are not limitless. When given the choice of equally effective diagnostic tests, treatment approaches, or medication options, physicians must consider which is likely to cost less. Our patients' needs are our first priority, but the health-care system we all depend upon is also our "patient."

Doctors must consider both the costs and benefits of treatments when choosing the best treatment for a sick patient.

NO Should doctors consider cost when treating a patient?

By David E. Rogers, M.D.

As stated in the American Medical Association's Declaration of Professional Responsibility, one of the duties of all physicians is to "Treat the sick and injured with competence and compassion and without prejudice." "Without prejudice" means to avoid any bias that could possibly interfere with or reduce the quality of care the patient receives. In my opinion, this would include considering costs when making treatment decisions.

Of course, a physician should not provide any unnecessary care just because the cost is covered. On the other hand, limiting or withholding care or choosing potentially inferior options just to reduce cost would be unethical. For physicians, the quality of the patient's medical care should always be the first and foremost consideration. I have always felt that "managed care" created cost-related, ethical dilemmas for physicians trying to act in a patient's best interest.

One economic model that brings physicians into direct conflict with cost considerations is the capitation system that is the basis of managed care. This is a system where a uniform or set fee is paid to the physician per patient (per capita) and in return the physician agrees to provide all the health care needed for those covered patients. The payment is not reduced if few services are necessary, so the physician makes more money when fewer services are rendered. However, the payment is no greater than if many services are provided. Physicians in this situation may actually be forced to operate at a loss. From a business standpoint, the incentive is to take care of only well patients and provide as little service as possible. Fortunately, most "capitation" agreements have disappeared because physicians refuse to compromise their patients' care in such a way.

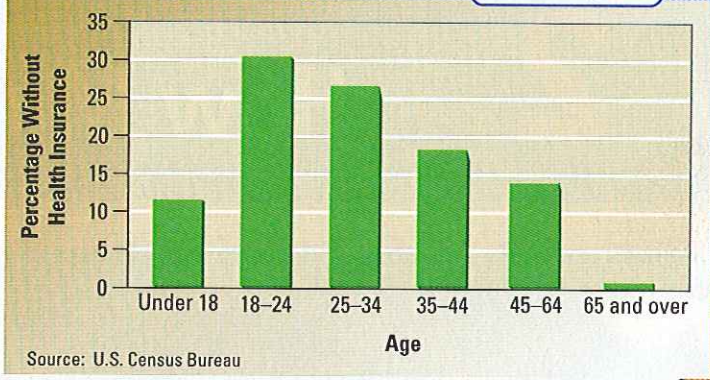
One example of where cost has played a role in medical decision-making can be found at your local pharmacy. Often, doctors will prescribe a brand-name drug and the patient will find that the generic version of the drug has been substituted. That's because many insurers require that if a generic version of a drug is available, that is what should be dispensed.

In most situations, generic drugs are just as effective as their brand-name counterparts. But there are many instances where the patient does not get the same desired effect.

We all like to say we are worried about costs—until we are the one who is sick or injured. When that happens, all we care about is getting well, regardless of the cost.

Go Online
PHSchool.com
Web Code: mng-1039

Uninsured Americans, 2003



Increasing health-care costs have led to higher prices for health insurance. As a result, more and more younger Americans do not have health insurance.

DEBATING THE ISSUE

1. Why does David Rogers disagree with "managed care"?
2. What data does Abbie Leibowitz cite to show that the health-care system is facing a crisis?
3. **Drawing Conclusions** The two authors disagree about whether a doctor's obligations extend beyond the patient to the overall public-health system. With which author do you agree? Why?
4. **Reading Graphs** Which age group's members are most likely to lack health insurance?

Go Online
PHSchool.com
For: You Decide Poll
Visit: PHSchool.com
Web Code: mnp-1031