

Some Economic Concepts (Ingram's Notes)

I. Basic definitions

1. Economics is the study of how societies use scarce resources to produce and distribute goods and services.
2. The economy is the activity of societies using scarce resources to produce and distribute goods and services.
3. Political economics and international political economics are the studies of the intimate relationship between political and economic behavior.
4. The political economy and the international political economy are the domestic and the international activities where the political and the economic aspects of societies merge.

II. Scarcity

1. Scarcity is the fundamental economic problem facing all societies. It arises from the reality that there are unlimited needs and wants in a world with limited resources. This requires an efficient use of those resources and a means to distribute the goods and services as the society determines.
2. "As the society determines" means that there are options and choices are made.

III. Opportunity Costs

1. A consideration in making choices is the opportunity cost.
2. When one uses resources to produce a good, those resources are not available to produce other goods. What is the criterion on which to base the decision about which good to produce?
3. One should produce the good with the lowest opportunity cost.
4. An opportunity cost is the cost of the **most desirable** alternative choice given up as a result of a decision.
5. How is **most desirable** determined?
6. What are **costs**?
7. Economics says that when resources are used to produce a good, the opportunity cost is what those resources could have also produced.
8. Opportunity costs focus us on alternatives.
9. Why are opportunity costs different for each individual? Costs are not only calculated in terms of resources. They are also calculated in terms what the individual values and the individual's interests.

IV. Costs and Benefits

1. A way to consider alternatives is to consider their costs and benefits.
2. For society, costs and benefits are not solely the resources used. Costs and benefits must also consider the interests and values related to the options not chosen..
3. The idea is to choose the option that has the highest ratio of benefits to costs compared to the other options.
4. The expectation is that all relevant costs and benefits have been identified.
5. Now the question arises, whose costs and whose benefits?
The individual, the group, the firm, society, other societies?
6. The choice has consequences that need to be weighed.
7. Here enters the economic and political processes of a society or possibly the world.

V. The "Three Basic Economic Questions"

1. The questions all societies must answer when dealing with scarcity and efficiently allocating their resources.
 - What to produce?
 - How to produce?
 - For whom to produce?

VI. Factors of Production/Resources

1. Land - natural resources above and below the surface
2. Capital - the human created means of production: factories, farms, machinery, infrastructure
3. Human Capital - the work force's capability, dependent on education and training
4. Financial Capital - the funds provided by lenders to businesses and states to develop land, capital, and human capital.
5. Entrepreneurship - the ability to assemble resources including innovations, finance and business acumen in an effort to transform innovations into economic goods. It involves inventiveness, initiative, risk taking.
6. Technology -
 - "Technology includes all tools, machines, utensils, weapons, instruments, housing, clothing, communicating and transporting devices and the skills by which we produce and use them." (Read Bain) The way we do things.
 - The ability to improve the way we do things.

VII. Basic Economic Systems

1. A traditional economic system is one in which people's economic roles are the same as those of their parents and grandparents. Societies that produce goods and services in traditional ways are found today in some parts of South America, Asia, and Africa. Tradition decides what people do for a living and how their work is performed. However, the answers to the three basic economic questions are determined by a mix of a market or a command economic system.
2. A market economic system is one in which a state's answers to the three basic economic questions are generally the result of individual decisions by consumers and producers in the competitive market. The market reflects the relationship of the demand and supply for goods and services. People fit into the economy according to their decisions, given the options in the market. In other words, allocation of resources is generally in response to market forces. However, one might consider Robert Heilbroner's comment: "The market has a keen ear for private wants, but a deaf ear for public needs."
3. In a command economic system, the answers to the basic economic questions are made by the government. The government decides what goods and services are to be produced and how. The government sells these goods and services. It also decides how people fit into the economy. In other words, allocation of resources is determined by the government. One might think that the opposite of Heilbroner's comment is suitable for a command economy. As the Soviet political economic system showed, however, the issue is not just public versus private, but what the public needs. The government alone cannot make that decision very well.

4. Economic systems also vary according to who owns the means of production. An economy's means of production are its capital: factories, farms, shops, mines, and machinery. The means of production are used to produce other goods and services.
- If the government owns and operates almost all of the nation's means of production, then that state's economic system is called **communism**. The USSR had a communist economic system. Almost all of the means of production were owned by the government.
 - If the government owns and operates many of the nation's major industries - such as banks, airlines, railroads, and power plants - but allows individuals to own other businesses, including stores, farms, and factories, that nation's economic system is called **socialism**. Sweden is an example of a country whose economic system is often described as socialist. Much of its major industries, such as coal mining, electric power, gas, telephone, and railroads, are owned by the government.
 - If almost all the stores, factories, and farms in a state are owned and operated by private individuals or businesses, then its system is called **capitalism**. The U.S. has a capitalist economic system. In the U.S., however, as in all capitalist countries, there are many examples of government ownership. Public colleges, high schools, and elementary schools, for example, are owned and operated by state or local governments. Other publicly owned enterprises are postal services, municipal bus lines and trains, often electric power plants, hospital, and housing projects.
 - Today no state has an economic system that is 100 percent communist, socialist, or capitalist. All countries today have **mixed economic systems**, with some free enterprise and some government ownership.
 - Notice that the above systems are economic systems, not political systems. An economic system does not determine the political system and vice versa. A capitalist economic system can exist in an authoritarian political system. An example is Germany under the Nazi regime. A socialist economic system can exist in a democratic political system. An example is Sweden. Theoretically, a communist economic system could exist in a democratic political system. However, the only communist economic systems have been authoritarian and totalitarian, the USSR and the People's Republic of China being the best examples.

VIII. Macro and Micro Economics

1. Microeconomics. The study of the behavior of people and businesses, especially their decisions regarding the allocation of resources. It focuses on individual markets and the forces that determine prices for goods and services. It also provides a basis for decision-making for specific companies in specific industry sectors.
2. Macroeconomics The field of economics that studies the behavior of the economy as a whole. It looks at the total performance of the economy, the effects of unemployment, economic growth, and inflation, and the effect of the government's fiscal and monetary policies.

IX. Basic Market Theory

1. Supply and demand are fundamental concepts of market theory. Demand refers to how much (quantity) of a product or service is desired by buyers. The quantity demanded is

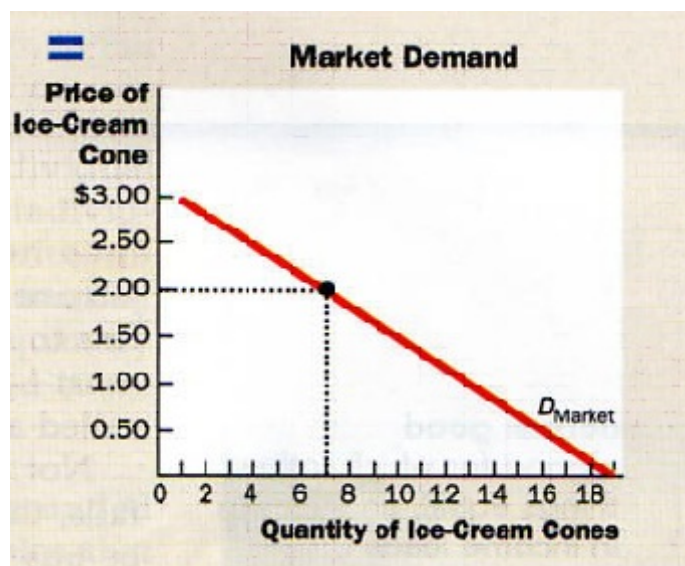
the amount of a product people are willing to buy at a certain price. Supply refers to how much of a product producers are willing to supply when receiving a certain price.

2. If the assumptions of the theory are met, the choices made in the market will cause the most efficient allocation of resources.

3. Demand

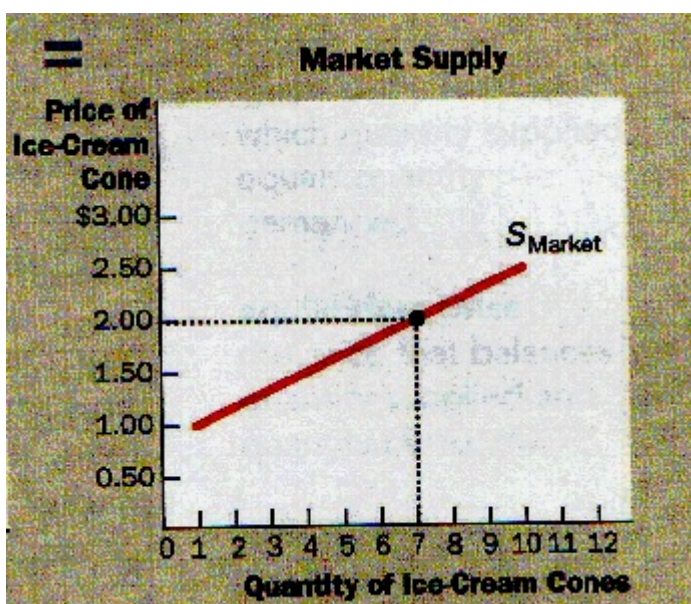
- The demand curve represents all the factors that cause people and businesses to want and to be able to buy a good or service. Among these are need, taste, alternatives, and income.

- The curve shows that, if all other factors remain equal, the higher the price of a good, the less people will demand that good. In other words, the higher the price, the lower the quantity demanded. The amount of a good that buyers purchase at a higher price is less because as the price of a good goes up, so does the opportunity cost of buying that good. As a result, people will naturally avoid buying a product that will force them to forgo the consumption of something else they want more.



4. Supply

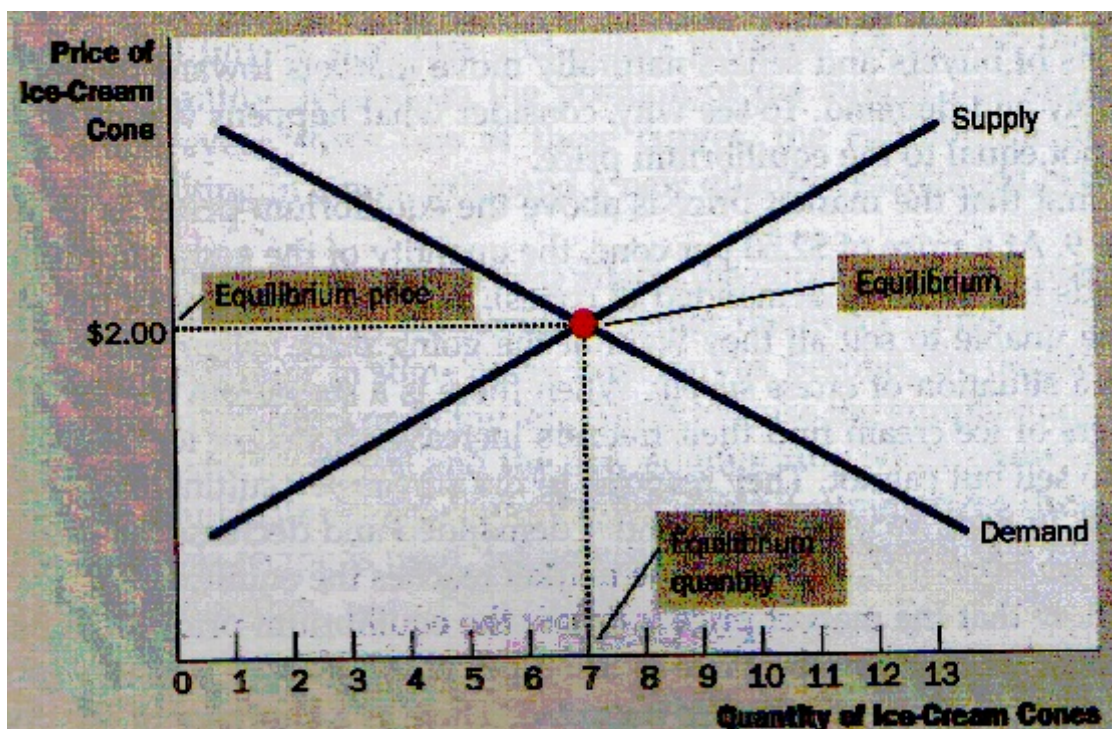
- The supply curve represents all the factors that affect production of goods and services. Among these are the costs of resources, such as labor, machinery, infrastructure, technology, and raw materials. The supply curve has an upward slope, because the higher the price, the more willing a producer is to produce the good or service. Producers supply more at a higher price because selling a higher quantity at a higher price increases revenue.



5. Price

- Demand and Supply are dependent functions that depend on the factors of demand and supply as noted above. However, in terms of determining the price of a good or service on the market, they are independent functions and the price is the dependent variable.

- Where the two curves cross is where the market sets the price for the good and service. At that point, those who want the good at that price and lower will buy from producers who are willing to produce and sell at that price. Obviously, some buyers and producers get a good deal, and other buyers and producers are not able or willing to buy or sell at that price.

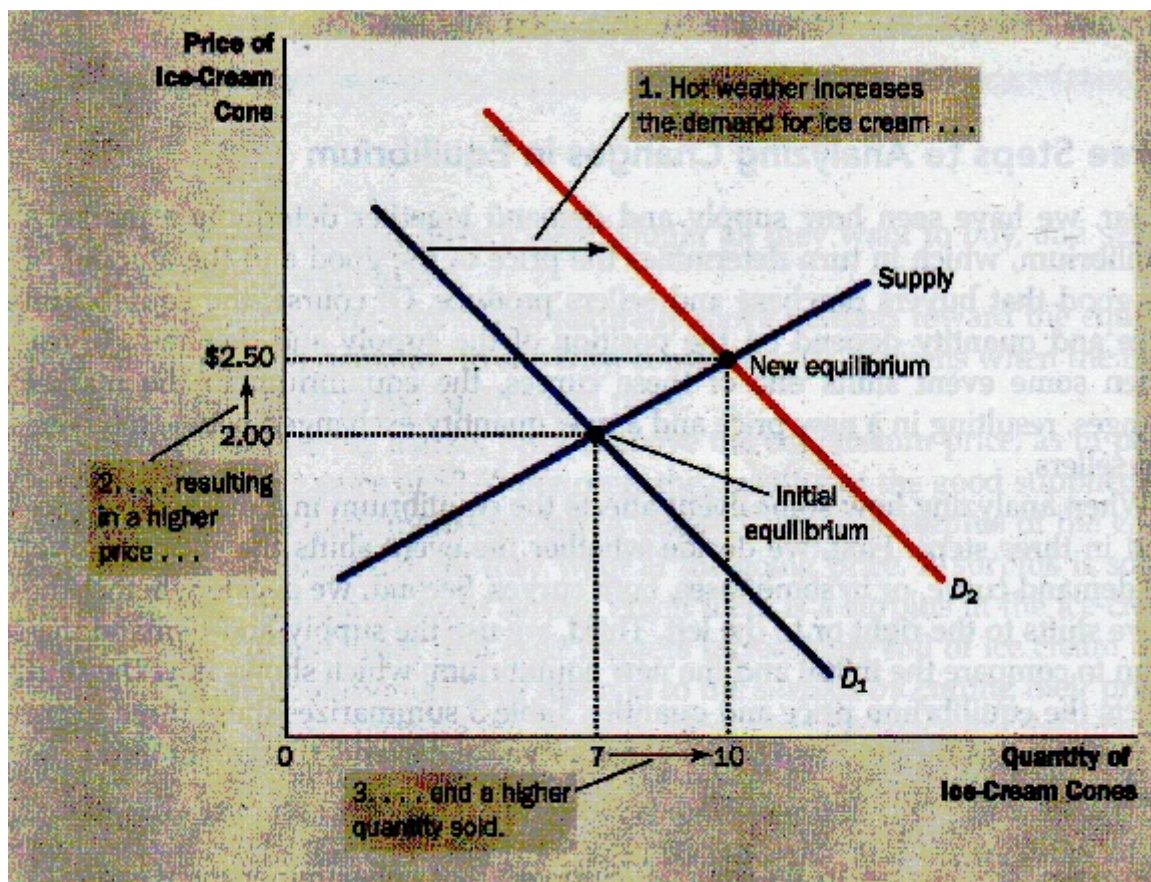
6. Changes in Supply and Demand

- If a factor that helps determine the supply or demand curves changes, then the curve moves left or right.

- For instance, if people shifted from the use of whale oil because they now could get electricity to light their homes, in other words there was an alternative, then the demand curve would shift to the left (appear to fall). The amount (quantity) demanded at each price would be less.

- Or, if the whales became scarce and the whalers had to spend more time at sea to get them, then the cost of producing whale oil would go up. The supply for whale oil would be reduced, because the amount (quantity) of oil offered at each price would be less. The supply curve would shift to the left (appear to rise).

- If either curve shifts, then the dependent variable, price, changes to reflect the new market conditions.
- There will be a new price and more or less of the good and service bought and sold.



X. Market Structural Failures (Market Power) (Also see XVI. 6.)

1. For market theory to reflect reality, its assumptions must be correct. Often the assumptions are close enough to reality for us to use the theory. However, for our current purposes, there is a serious possible problem -- when someone has the power to influence the supply of a good or service. In these cases, the assumption of perfect competition does not hold. Below are two examples of such power.
2. Monopoly
 - A monopoly is a market structure in which there is only one producer/seller for a product. That producer has control over the supply curve. It determines how much to produce.
 - The entry into such a market is restricted due to high costs or other impediments, which may be economic, social or political. For instance, a government can create a monopoly when there is an industry that it wants to control, such as electricity. Another reason is barriers to entry of competitors into the industry, such as when one company has the

exclusive rights to a natural resource. For example, in Saudi Arabia the government has sole control over the oil in the country. Another example is when a company has a copyright or patent that prevents others from entering the market.

- The problem exists, not because of the structure, but because of the possible behavior of the organization with the monopoly. A monopolist organization may behave in a manner that is disruptive to the economy and contrary to the best interests of the population. This is seen in predatory manipulation of production, transporting, and selling prices aimed at driving out or discouraging competition. The threat that a monopoly poses to directly to consumers is that it denies them the benefit of choice and competition. It can use its position to impede competition and restrict production. Thus, there are artificial shortages and higher prices. Therefore, the need for anti-trust laws.

3. Oligopoly

- In an oligopoly, there are only a few firms that make up an industry. This select group of firms can control the supply curve, by controlling how much is produced. Like a monopoly, an oligopoly has high barriers to entry. The products that the oligopolistic firms produce are often nearly identical and, therefore, the companies, which are competing for market share, are interdependent as a result of market forces.

- The ideal example is not a group of firms, but a group of states – OPEC. OPEC does not control all oil that is produced, but because its member states control so much of what is produced, its decisions can heavily affect the supply curve. The result is almost to control that curve for oil. OPEC's effective market power is, however, dependent upon the willingness of its member states to act in accordance with the decisions of the group.

XI. Market Failure

1. In addition to inadequate competition, there are other common market failures, which are situations where the market does not provide the expected benefits of efficiency and flexibility.

2. Resource Immobility. The efficient allocation of resources requires that land, labor, entrepreneurs, technology, and financial capital be free to move to markets where returns are the highest. But there are times when a business cannot move, or labor prefers to stay in one place, or finances are not allowed to leave a country, or technology is controlled. Resource mobility is critical in the competitive market economy, but it is difficult to accomplish. When resources are immobile, markets don't function, as they should.

3. Public goods. Public goods are those goods and services provided by the government. Sometimes it is in our benefit to not allow for a market provision. In the case of police, national defense, and public education it can be argued that private provision of these services would be less desirable for a variety of reasons. (Also see XVI.2.)

- Public goods are economic products that are consumed collectively, like highways, sanitation, schools, national defense, police and fire protection. All members of society should theoretically benefit from the provision of public goods but the reality is that some need them more than others. For example the wealthy do not need welfare and the elderly still pay for school taxes. This leads to the inevitable argument about paying for public goods.

- Because everyone has the benefit of public goods, those who do not pay for those

goods have a free ride. This is the free-ridership problem. This transfers the cost of these goods to those who do pay. There is a strong social argument for society to take care of those who cannot take care of themselves. There is no justification, other than the problem of collection, for those who can pay for a service not paying.

4. Externalities. This occurs when a good is produced that has a cost or a benefit to someone not involved in the market.
 - A negative externality is a harmful side effect that puts a burden, usually a cost, on an uninvolved third party. A common example is pollution. The producer causes the pollution, but neither he nor the buyer pays for its effect on others. (Also see XVI.3.)
 - A positive externality is a beneficial side effect. If the town has a trade school, which trains students in certain skills, and a firm needs workers with those skills, but pays taxes to another town, that firm benefits without paying. (Also see XVI.4.)
5. Macroeconomic instability. Markets do not perform well when there is severe inflation, significant unemployment, or high rates of business failure. In other words, during depression, significant recessions, and periods of monetary instability.

XII. Effective Demand

1. A way to consider how well an economy is doing is with the concept of effective demand. This is a measure of nationwide economic performance.
2. Effective demand is measured as a state's gross domestic product (GDP). In actuality, this is not a fully effective way to measure performance. Much economic activity is left out.
3. GDP expenditures are the sum of four types of buyers: 1) consumers, 2) investors, 3) governments, and 4) foreigners. $GDP = C + I + G + (\text{exports} - \text{imports})$.
4. Fiscal Policy. Fiscal policy is usually designed to try to maintain a GDP on a steady upward path by increasing G when C and I are falling, causing unemployment. Or decreasing G when C and I are rising too rapidly, threatening inflation. (Also see XVI.8.)

XIII. Money

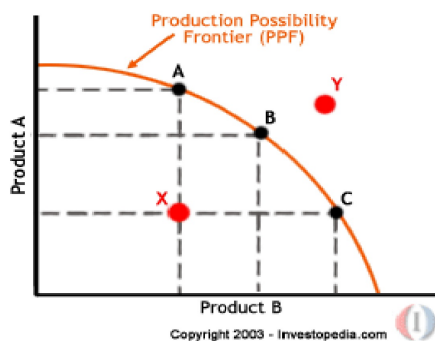
1. Money has three functions.
 - medium of exchange. We use it to buy things, rather than having to trade in goods, bartering.
 - unit of account. It is a standard numerical unit of measurement of the market value of goods, services, and other transactions.
 - store of value. Money must be able to be reliably saved, stored, and retrieved and be predictably usable as a medium of exchange when it is retrieved. The value of the money must also remain stable over time. In that sense, inflation by reducing the value of money, diminishes the ability of the money to function as a store of value.
2. Monetary Policy. This is a way for the government to try to manage the economy of its society. By adjusting the availability of money, the government can affect economic behavior. Increasing the supply of money should increase economic activity, good when unemployment is high, bad when inflation is high. Decreasing the supply of money should have the reverse effect. (Also see XVI.8.)
 - Money supply is the amount of any financial instrument that can fulfill the functions of money. Cash and credit cards are the types of money we usually use.

- Liquidity describes how easily an item can be traded for another item, or into the common currency within an economy. Cash is the most liquid asset because it is universally recognized and accepted as the common currency. In this way, money gives consumers the freedom to trade goods and services easily without having to barter. Liquid financial instruments are easily tradable and have low transaction costs.
- Other financial instruments are less liquid, such as bank deposits, stocks, and bonds.

XIV. Economic Goals

- High Efficiency
- Economic Growth
- Fair Income Distribution
- Full Employment
- Controlled Inflation
- Adequate Stability
- Economic Freedom
- Security against Economic Risk
- Social well-being
- Individual well-being
- High Living Standards
- High Human Development
- Achieved Non-Economic Goals

XV. The production possibility curve and its explanatory significance will be developed in class.



XVI. GOVERNMENT IN A MARKET ECONOMY (usinfo.org) (Department of State)

1. If markets and market systems are so efficient, why let the government tamper with their workings at all? Why not adopt a strict policy of what is called laissez-faire and allow private markets to operate without any government interference whatsoever? There are several reasons that economists and other social observers have identified, which can all be illustrated with some familiar examples. In most cases, however, the role of government is not to take the place of the marketplace, but to improve the functioning of the market economy. Further, any decision to regulate or intervene in the play of market forces must carefully balance the costs of such regulation against the benefits that such

intervention will bring.

2. **National Defense and the Public Good**

National defense is one example where the role of government is indispensable. Why? Because the defense of a nation is a type of good that is completely different from oranges, computers, or housing: people do not pay for each unit they use, but purchase it collectively for the entire nation. Providing defense services to one individual doesn't mean there is less defense for others, because all the people, in effect, consume those defense services together. In fact, national defense services are even provided to people in a country who don't want them, because there really isn't an effective way not to. Nations can afford to build jet fighters; neighborhoods or individuals cannot.

This type of good is called a public good, because no private business could sell national defense to the citizens of a nation and stay in business. It simply doesn't work to sell defense services to those who want them and then not protect the people who refuse to help pay for them. And if they can get the protection without paying for it, why would they choose to pay? That is known as the "free rider" problem, and it is the key reason why national defense must be administered by the government and paid for through taxes.

There aren't many true public goods -- goods that can be jointly consumed and that are subject to extensive free-rider problems -- which is why most goods and services in market economies can be produced and sold by private firms in private markets. Other examples of public goods include flood- and insect-control programs, and even radio and television signals broadcast over the airwaves. Each of those products can be jointly consumed by many consumers at the same time and is subject to free-rider problems, at least to some degree. With television and radio broadcasts, however, programs can be privately and profitably produced by selling broadcast time for advertising. Or in some cases, broadcast signals are now electronically scrambled, so private firms can make money by renting out decoding machines to people who want to see these broadcasts.

3. **Pollution and External Costs**

Let's take the example of a company that manufactures paper products -- from writing paper to cardboard boxes -- at a factory location on a river. The problem is that, as a by-product of its manufacturing operations, the factory dumps chemical pollutants into the river. But no single person or entity owns the river water, so there is no one to force the company to stop polluting. Moreover, since cleaning up the river would cost money, the company can sell its paper products more cheaply than if it had to absorb such pollution-control costs. As a result, the paper company can further increase its output, responding to the relatively higher demand at its lower prices, leading to more waste and pollution from its factory. By polluting without penalties, the company may also have an unfair advantage over competitors whose paper products do reflect the cost of installing pollution control equipment.

This is a classic example of a so-called external cost that is not reflected in the price through normal workings of the marketplace. Neither the paper company nor its

customers are bearing the actual cost of paper production; instead, a portion of the cost -- the pollution factor -- has been shifted to the people who live or work along the river and those taxpayers who eventually are stuck with the cleanup bill.

Like other externalities, pollution often occurs where the ownership of a resource -- in this case the river -- is not held by individuals or private organizations. Public lands and roadsides, for example, are more often littered than the lawns in front of people's homes, because no one person owns these public lands and takes the responsibility for keeping them clean, and prosecuting those who despoil them. Most pollution is, in fact, released into the air, oceans, and rivers precisely because there are no individual owners of those resources who have strong personal incentives to hold polluters liable for the damage they do. While some people do take the time and trouble to prosecute such polluters, there are few economic incentives for most people to do so.

Government's role in this situation is to try to rectify this imbalance. By intervening, government can force the producers and consumers of the product to pay these cleanup costs. In essence, this economic role of government is simply to make those who enjoy the benefits of selling and consuming a product pay all of the costs of producing and consuming it.

Unfortunately, it is rarely easy for the government to determine just how much it should do in these cases. For one thing, it is usually difficult and costly to determine the precise source of pollution or exactly how much the pollution is actually costing society. Because of these difficulties, the government must be sure that it doesn't impose more costs to reduce pollution than the pollution is costing society in the first place. To do so would clearly be inefficient and a waste of valuable resources.

Once the government has established an acceptable, or at least tolerable, level of pollution, it can use laws, regulations, fines, jail sentences, even special taxes to reduce the pollution. Or even more fundamentally, it can try to establish clearer ownership rights for the resources that are being polluted, which will result in market-based prices being charged for the use of those resources and force polluters to pay those costs. Amid these many options, the key point is to understand the government's basic role -- to correct for the overproduction and overconsumption of goods and services that lead to external costs.

4. **Education and External Benefits**

When Robert returned to school to become a computer programmer, he was seeking to better himself and his family, not necessarily improve the community at large. But as a result of his advanced education, Robert became a more highly trained and productive member of his society. He now possesses new skills and has founded a new business that, in turn, provides jobs and opportunities for others.

Here, Robert's education has benefits that are enjoyed by people other than the producers and consumers of some good or service. Education is often claimed to offer external

benefits in a nation, because educated workers are more flexible and productive, and less likely to become unemployed. That means spending more for education today may ultimately lead to savings in public and private spending to fight crime, poverty, and other social problems, as well as increasing the skill level, flexibility, and productivity of the work force.

To the extent that any product does generate significant external or spillover benefits, governments may consider subsidizing or otherwise encouraging its consumption, production, or both, so that the value of the external benefits are included in the market price and output level of these products. Just as external or spillover costs lead to overproduction of certain goods, the existence of external benefits will lead to underproduction of other products and services.

Public education is perhaps the largest and most significant example of government expenditures and support for a service regarded as having significant external benefits. There are, however, relatively few situations where government intervenes to set prices, whether through subsidies or taxes, to encourage such external benefits. In general, the extension of property rights and a system of market-based prices can often be the most effective means whereby government can right the imbalances caused by external costs and benefits.

5. **A Legal and Social Framework**

Market economies, despite the obvious examples of abuse, are not licenses for exploitation or theft. In fact, very little trading in markets takes place in societies when the legal rights of consumers and producers to own and trade economic resources aren't clearly recognized and protected. That is why governments in market economies keep records of deeds to land and houses, and enforce contracts between buyers and sellers of virtually all kinds of products. Buyers want to know that the things they buy from sellers are really theirs to sell; and both buyers and sellers want to know that when they agree to exchange something, that agreement will be carried out. The same holds true for workers who, either individually or collectively in unions, agree to wages and working conditions with their employers. If those assurances aren't provided routinely and effectively, and if a fair and impartial criminal justice system isn't in place, market dealings become more expensive and difficult to complete.

Governments in market economies must establish and protect the right to private property and to the economic gains derived from the use of that property. Without such assurances, few people are going to risk their time and money in enterprises whose rewards may possibly go to the state or some other group. When Robert and Maria contemplated starting R&M Educational Software, for example, they knew that they ran the risk of economic failure; but they also knew that if they succeeded, the laws protecting private property would enable them to reap the economic rewards of that success.

The government's protection of private property obviously extends to land, factories, stores, and other tangible goods, but it also extends to so-called intellectual property: the

products of people's minds as expressed in books and other writings, the visual arts, films, scientific inventions, engineering designs, pharmaceuticals, and computer software programs. Few entrepreneurs or companies will invest in the often expensive and time-consuming research into new drugs to fight disease, new computer programs, or even publish new novels if rival companies can simply appropriate and market their work without paying royalties or other fees that reflect their production costs.

To protect and encourage scientists and artists, governments issue exclusive rights, called copyrights, to protect certain kinds of intellectual properties such as books, music, films, and computer software programs; or called patents when they protect other types of inventions, designs, products, and manufacturing processes. These exclusive rights give the holders, whether individuals or corporations, exclusive rights to sell or otherwise market their products and creations for a specified period of time. As President Abraham Lincoln said, they add "the fuel of interest to the fire of genius."

In defining and enforcing property rights and maintaining an effective legal system, governments can build a social environment that allows private markets for most goods and services to function effectively and with widespread popular support.

6. **Competition**

Each month, Robert and Maria, regularly pay bills to the local water utility and local telephone company. Unlike most of the other enterprises in a market economy, neither the water utility nor the telephone company compete with rival enterprises who also provide water and telephone service.

The reason is that both services are so-called "natural monopolies," whose services are provided most economically by only one firm. Permitting two sets of water pipes or entirely separate telephone or electrical lines would be wasteful and inefficient in the extreme. Instead of controlling costs and maximizing efficiency through competition, government agencies regulate the prices and services of these companies to ensure that they offer the best possible prices to their customers and still receive a satisfactory rate of return on their investments.

The number of such "natural monopolies" is actually quite small and accounts for only a small proportion of the economic activity in most market economies. A more common, and in many ways more complex, problem arises when one industry is dominated by a few large firms. There is a real danger that these firms may collude to set higher prices and to limit entry by new, competing firms. To prohibit such monopolies and collusive behavior, and to maintain a more effective degree of competition in the economic system, so-called antitrust laws have been passed in most market economies, including the United States.

Limited competition may occur in some industries, such as aviation, because the level of market demand is only sufficient to support a few large companies -- given the most efficient production technologies for such products. Policymakers must therefore decide

whether the competition between the small number of large companies that produce such products is adequate to keep prices and profits down to reasonable levels and product quality high. If not, they can again turn to some kind of price and service regulation, or legally break up some of the large companies into smaller companies, if that can be done without driving up production costs substantially. Failing that, the policymakers can at least make it illegal for these few large companies to collude with one another and enforce those laws to ensure that there is as much direct competition between these companies as possible.

Unfortunately, many government regulations and antitrust policies actually reduce competition rather than increase it. These policies include exclusive licenses to produce a good or service, taxes, quotas that limit imports of foreign goods and services, and occupational licensing requirements and fees for professional and skilled workers. Some of these policies, such as offering patents and copyrights, can be justified on other economic grounds. Other restrictions are not so sensible, however, and are adopted only because they provide large benefits to members of narrow special interest groups. Because the costs of those restrictions are spread so widely among the rest of the population, they attract little or no public disfavor.

On balance, despite these frequent shortcomings, the consensus position of economists in market economics is that the potential costs of allowing large firms (or a group of colluding firms) to achieve monopoly positions in key industries are very high. They are sufficiently high, in fact, to justify a limited government role in developing laws and regulations to maintain competition.

7. **Income and Social Welfare**

Some people do not have the skills or other resources to earn a living in a market economy. Others benefit greatly from inherited wealth and talents, or from the business, social, and political connections of their families and friends.

Governments in market economies inevitably engage in programs that redistribute income, and they often do so with the explicit intention of making tax policies and the after-tax distribution of income more fair.

Proponents of extensive redistribution argue that this role of government limits the concentration of wealth and maintains a wider diffusion of economic power among households, just as antitrust laws are designed to maintain competition and a wider diffusion of power and resources among producers. Those who oppose major redistribution programs counter that additional taxes on high-income families decrease the incentives of these groups to work, save, and invest, to the eventual detriment of the overall economy.

The debate over income redistribution comes down to people's basic ideas about what is equitable and fair. And in that area, neither economists nor other experts who study the

issue have any special standing.

All they can do is document what has happened to the distribution of income and wealth over time in different kinds of economic systems, and use that information to try to identify how different policies affect such variables as national levels of production, savings, and investment.

A social consensus has developed during this century that governments in most market economies should, out of compassion and fairness, play a role in providing for the neediest families in the nation and help them try to escape a life of poverty. Governments in virtually all market economies provide support for the unemployed, medical care for the poor, and pension benefits for retired persons. Taken together, these programs provide what is sometimes called a "social safety net."

Over the last 40 years these social programs have been rapidly growing parts of government spending and taxation programs in most industrialized economies. So the current debate over these programs is not really about whether they should exist, but rather about how extensive they should be and how such income redistribution programs can be administered while still preserving individual incentives to work and save.

8. **Government Fiscal and Monetary Policies**

Governments in market economies play critical roles in providing the economic conditions in which the marketplace of private enterprise can function most effectively.

One such role is to provide a widely accepted, stable currency that eliminates the need for cumbersome and inefficient systems of barter, and to maintain the value of that currency through policies that limit inflation (an increase in the overall level of prices of goods and services).

Historically, market economies have been periodically afflicted by periods of rapidly rising price levels, at other times with high levels of unemployment, or occasionally by periods with both high rates of inflation and unemployment.

Many of these episodes were, fortunately, relatively mild and short-lived, lasting a year or less. A few were more persistent and far more serious, such as the German hyperinflation of the 1920s and the worldwide unemployment of the 1930s known simply as the Great Depression.

Only in this century have economists and government policymakers developed a standard set of stabilization policies -- known as fiscal and monetary policies -- that national governments can use to try to moderate (or ideally to eliminate) such episodes.

Fiscal policies employ government spending and tax programs to stimulate the national economy in times of high unemployment and low inflation, or to slow it down in times of high inflation and low unemployment. To stimulate the overall level of spending, production, and employment, the government itself will spend more and tax less, even if it incurs a deficit. (It will then have to run an offsetting surplus at some time in the future.)

To slow down an overheated economy -- one where virtually everyone is working

who wants a job, but where spending and prices are rising rapidly -- the government has several options to keep prices from spiraling too high. It can cut its own spending, raise taxes, or both, in order to lower aggregate spending and production levels.

Monetary policy involves changes in a nation's supply of money and the availability of credit. To increase spending in times of high unemployment and low inflation, policymakers increase the supply of money, which lowers interest rates (that is, reduces the price of money), thereby making it easier for banks to make more loans. This encourages more spending on consumption by putting additional money in people's hands. Lower interest rates also stimulate investment spending by businesses seeking to expand and hire more workers.

In a period of high inflation and low unemployment, by contrast, policymakers can cool down the economy by raising interest rates, thereby reducing the supply of money and the availability of credit. Then, with less money in the economy to spend and higher interest rates, both spending and prices will tend to fall, or at least increase less quickly. As a result, both output and employment will tend to contract.

Monetary and fiscal policies were not widely used to stabilize the ups and downs of national business cycles before the 1960s. Today, except in cases of major natural and human disasters -- such as wars, floods, earthquakes, and droughts -- these stabilization policies can be used to avoid severe periods of unemployment and inflation. But their effectiveness against shorter and milder swings in national economic performance, or in dealing with situations where both unemployment and inflation are rising, is much less certain.

There are several reasons for that uncertainty, including the time required to recognize exactly what the problem is, to design the appropriate mix of policies to address the problem, and, finally, to wait for those policies to take effect. One very real risk is that by the time the government's policies have taken effect, the original problem will have corrected itself or moved in another direction entirely. In that case the stabilization policies may prove to be unnecessary or even counterproductive.

When both unemployment and inflation rise at the same time, however, governments can face a dilemma. The reason is that monetary and fiscal policies are designed to adjust the level of total spending in a nation, but not to cope with a relatively sudden decline in supplies, which can trigger inflation and unemployment simultaneously. When can such a situation arise? One case occurred in the 1970s when embargoes on oil exports by major oil-producing nations caused huge price rises that rippled through the economies of the industrialized nations. Such decreases in supply raise price levels while lowering production and employment levels.

To deal with such supply shocks to a national economy, a government can try to increase people's incentives to produce, save, and invest; increase the effective level of competition in the nation by reducing monopoly power; or eliminate bottlenecks of key resources, whether a commodity such as oil or certain kinds of skilled labor like engineers. In the case of oil-export restrictions, for example, the nation can stimulate domestic oil production, provide incentives for greater energy efficiency and conservation, and invest in alternative energy sources. However, most of these so-called

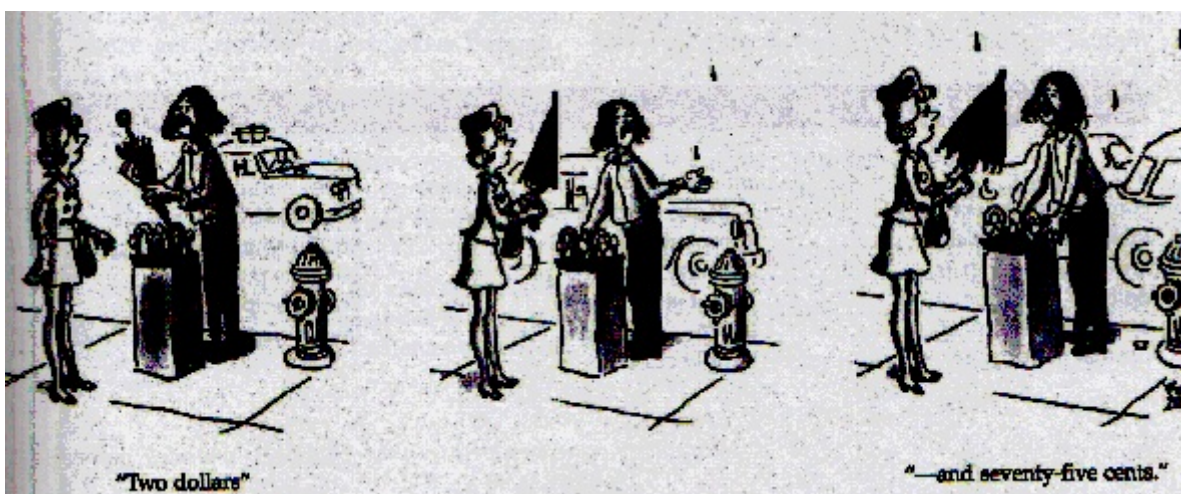
supply-side policies tend to work slowly, over periods of years rather than months.

While governments can offer no panaceas in the long-standing fight against inflation and unemployment in market economies, they can be effective in moderating the effects of these problems.

Most economists now acknowledge an important government role in fighting unemployment and inflation with long-term stabilization policies, including generally stable rates of growth in the money supply, government spending programs that automatically rise when the economy slows down and fall when the economy picks up (such as benefits paid to unemployed workers), and tax schedules that reinforce those automatic spending programs by taking less from consumers and workers when their incomes fall and more when their incomes rise.

Short-run monetary and fiscal policies adopted by policymakers to deal with temporary but sometimes sharp increases in unemployment or inflation are also employed in many market economies, although economists disagree much more on both the timing and effectiveness of these policies.

In the end, it is important to recognize that in any type of economic system, including a market economy, some problems exist that can never be entirely or permanently solved. These problems have to be studied pragmatically on a case-by-case basis, with a careful consideration of the economic and political forces that influence them. And it is at this juncture that a democratic political system -- one which encourages dissent and open discussion of public issues -- can contribute most effectively to the operation of a free-market economy.



The capitalist entrepreneur at work at the consumer interface.