CHAPTER 2

Government and the Economy

Reading for Meaning

The summary at the end of the chapter highlights the most important concepts. Read the summary first. Then make sure you understand those concepts as you read the chapter.

- business cycle
- recession
- depression
- inflation
- stagflation
- labor force
- unemployment rate
- underemployment
- fiscal policy
- gross domestic product (GDP)
- consumer price index (CPI)
- labor union
- monetary policy
- Federal Reserve System
- tax
- deficit spending
- national debt
- perfect competition
- monopoly
- oligopoly
- collusion

CHAPTER OBJECTIVES

After studying this chapter, you will be able to

- **diagram and explain** the four parts of the business cycle.
- **compare** and contrast recession, inflation, and stagflation.
- **describe** how the government uses fiscal and monetary policy to combat inflation and recession.
- **explain** the economic consequences of government taxingand spending.
- **explain** how the national debt hurts the economy.
- **describe** the government's role in promoting competition.
- **identify** the laws and government agencies that protect consumer interests.

Central Ideas

- The goal of government economic policies is to create economic stability and prosperity for its citizens.
- Government enacts laws and regulations to ensure fair competition and to protect the public well-being and safety.
- Government agencies at all levels of government assist and protect consumers by providing information, protection, and services.

The U.S. economic system is called a market or a free enterprise system. Compared with many other nations, the United States government plays a small role in the economy. However, the economy could not function without certain types of government participation.

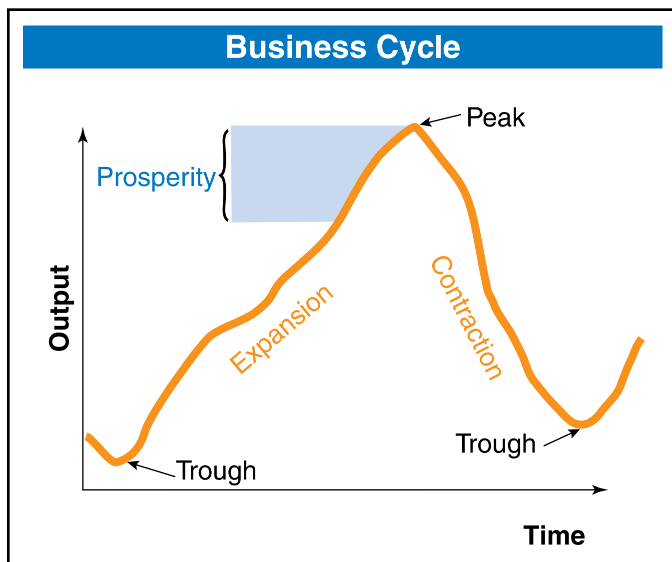
For example, government provides the legal and institutional environment that permits and encourages economic activity. Government protects individual liberties and private property rights and enforces contractual agreements. It provides the political stability and the *rule of law* that are necessary for economic prosperity. This is what enables individuals and businesses to carry out productive economic activities.

Government plays these specific roles in the operation of our economy:

- It sets economic policies in an effort to create stability and prosperity.
- It makes tax and spending decisions in response to economic conditions.
- It controls the money supply.
- It regulates business and economic activity to ensure fair business practices and to protect public well-being and safety.

The following section explores these government functions in greater detail.

Economic Conditions Monitored by the Government



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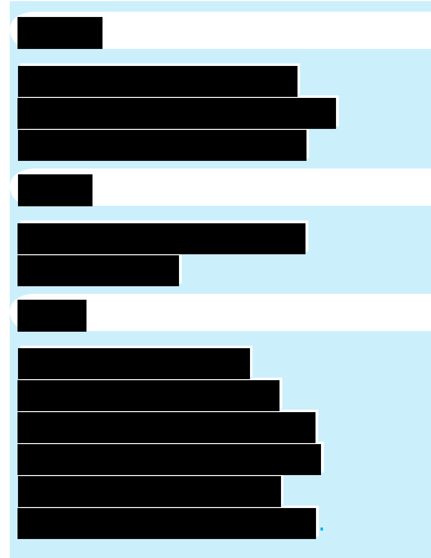
One business cycle consists of the time from one trough to the next.

The U.S. economy fluctuates between periods of economic growth and slowdown. This is true of economies in other industrialized nations as well. The term **business cycle** describes these ups and downs, 2-1. Some economists prefer the term *business fluctuations* because there are not predictable patterns to the ups and downs. The business cycle has four parts.

- *Contraction* is a period of slow or no growth.
- *Trough* occurs when a contraction stops.
- *Recovery* is the period when business activity begins to grow again.
- *Peak* is the height of recovery and lasts until growth begins to slow again. Then the cycle starts all over again.

Each period can last months or even years. For example, the longest economic expansion in modern U.S. history occurred during the 1990s and lasted 10 years. However, the average length of an expansion is about three years. Economists use measurements, or *indicators*, to figure out how the economy is doing and to try to predict its direction.

The following sections describe the most serious problems of a troubled economy.



Recession and Depression

When the business cycle starts a downward trend, people fear a **recession**, which is an extended period of slow or no economic growth. Technically a recession exists if negative growth lasts two quarters or more. (The business year is divided into four three-month quarters.) A recession is marked by

- high unemployment
- a decline in retail sales
- lowered average personal incomes
- decreases in consumer spending
- reduced spending by businesses on plants, equipment, and expansion

Overall economic activity declines. People lose their jobs and businesses fail. It may also be difficult to obtain a mortgage for a home, or to start a new business. When a recession goes on for several years, which is rare, the economy is said to be in a **depression**.

During the Great Depression of the 1930s, one out of four workers was unemployed. Pay cuts were common among those who had jobs. People lost their savings and investments. There was mass hunger, homelessness, and migrations of people across the country looking for work. It lasted for almost ten years. More recently, in 2008, the economy went into a recession and again many people lost their jobs and homes, businesses failed, and the value of savings and investments fell dramatically.

Inflation

Inflation is an overall increase in the price of goods and services. It threatens the nation's prosperity because it decreases the value of a dollar. Due to inflation, today's dollars buy less than last year's dollars.

For example, in 2006, a family that made an income of $65,000 could buy $65,000 worth of goods and services. However, in 2009, they would need $69,434 to buy the same goods and services. That extra $4,000 is the impact of inflation. The CPI Inflation Calculator at the Web site of the U.S. Department of Labor's Bureau of Labor Statistics calculates the cost of inflation. It is at http://data.bls.gov/cgi-bin/cpicalc.pl.

According to government data, the U.S. inflation rate is fairly low compared with the rates of other countries. For example, in 2008, the estimated rate of inflation in the U.S. was 4.2 percent. However, in India it was estimated at 7.8 percent. In Russia, it was about 14 percent, and in Iran it was 28 percent. Inflation is especially hard on individuals and families who live on fixed incomes. Income stays the same over the years, while costs climb. There are several types of inflation.

Demand-Pull Inflation

This type of inflation occurs during the recovery and peak periods of the business cycle. When the economy is growing, consumers are more likely to be employed and have spending money. Spending increases at a faster rate than supply. Put another way, there are too many dollars chasing too few goods. According to the laws of supply and demand, as demand goes up, so do prices.

Cost-Push Inflation

This type of inflation is triggered by an increase in the price of a widely used good. For example, when the price of oil rises, consumers pay more for fuel to power their cars and heat their homes. Many other goods and services—from food and flowers to building materials and airfares—increase in price as well. This is because so many businesses require fuel to operate and bring goods to market. Petroleum is also an ingredient in many products, particularly plastic.

Stagflation

Stagflation describes a period of slow growth (economic stagnation) and high inflation. The best-known episode of stagflation took place during the 1970s. Oil producers raised oil prices that triggered inflation as the costs of many goods and services rose. This occurred at a time of slow growth and high unemployment.

Impact of Unemployment and Underemployment

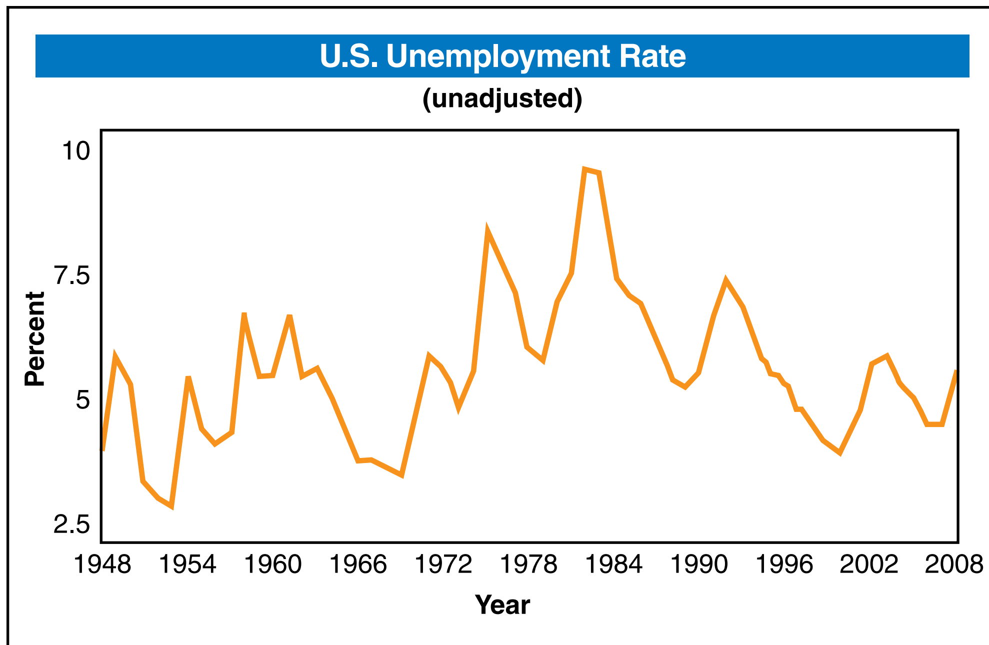
A nation's prosperity and stability depend on full use of its productive resources, including the labor force. This is one of the goals government seeks to achieve through its economic policies. The **labor force** is composed of people, age 16 and over, who are employed or looking for and able to work.

The **unemployment rate** is the percentage of the labor force that is out of work and seeking employment. That percentage fluctuated between 4 percent and almost 10 percent over the past 30 years, 2-2. Unemployment figures are closely tied to business fluctuations. The highest unemployment rates occur during periods of contraction.

Unemployment hurts workers and their families. When the family breadwinner is unemployed, the entire family suffers. Some families must move because they lose their homes or cannot afford to make rent payments. Some people go into debt and lose health benefits that are usually provided through an employer. Unemployment is also associated with health problems such as stress-related illnesses, depression, and substance abuse. There are several types of unemployment that economists consider.

Labor Economists

Labor economists study changes in the supply and demand for labor. They analyze reasons for unemployment, identify factors that influence the labor market, and collect data on wages. Labor economists usually work for the government.



Bureau of Labor Statistics

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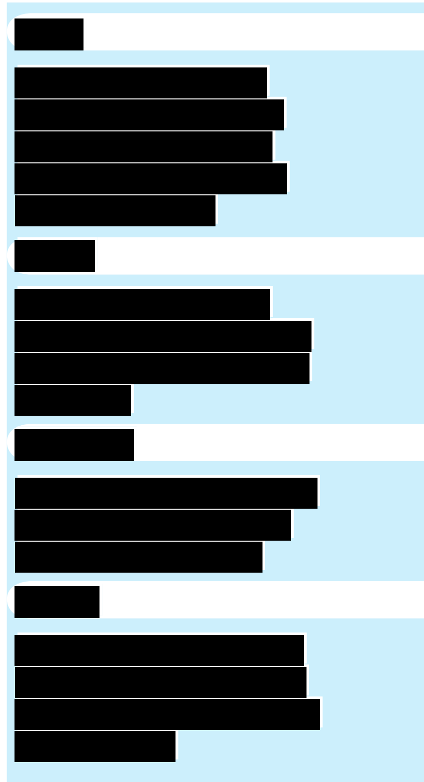
The U.S. Department of Labor keeps track of the civilian unemployment rate.

Frictional Unemployment

This is short-term unemployment that affects people who are between jobs. These are people who have moved or changed jobs or careers. They can often find employment by matching their qualifications to available jobs. Some workers will be temporarily unemployed even in a strong and growing economy.



Structural Unemployment

Structural unemployment tends to be long-term, difficult to correct, and the most damaging to both workers and the economy. It refers to unemployment among workers who drop out of the labor force or do not enter. There may be a mismatch between their skills and available jobs. Often the old jobs were moved to cheaper labor markets or eliminated by new technology.

Cyclical Unemployment

Cyclical unemployment is tied to the business cycle. It occurs when the economy slows or is in a recession. Workers are laid off. When the economy moves into the recovery phase, workers are rehired.

Seasonal Unemployment

Finally, there is *seasonal unemployment* that is related to jobs that depend on seasonal activities. This includes the extra workers hired for the holidays, for vacation season, and for crop harvesting. Seasonal jobs end when the short-term demand for workers ceases.

Underemployment

In addition to the unemployed, a percentage of the labor force will be *underemployed*. **Underemployment** refers to workers who are employed only part time or who are "over qualified" for their jobs. They are the skilled workers who hold jobs requiring few skills. Some of these workers are underemployed by choice, but most cannot find work at their skill or educational level.

Continuing prosperity and stability require the workforce and other productive resources to be employed at full capacity. This is one of the goals government seeks to achieve through its economic policies.

Factors Affecting Economic Policies

The economy is incredibly complex and difficult to understand and predict. The primary and difficult challenge for government is to soften the ups and downs of the economy. Government policies are intended to increase growth and employment and to keep inflation low. Another goal of government, covered in Chapter 4, is to ensure the proper balance of trade in world markets.

Fiscal Policy

Fiscal policy refers to the federal government's taxing and spending decisions. Government often uses fiscal policy to stimulate the economy in periods of recession and high unemployment. Fiscal policy can also slow economic activity in periods of inflation or rising prices. The government's taxing and spending decisions are made in Congress. They are driven by economic indicators and analysis of the economy.

Gross Domestic Product

The economy is described in terms of many indicators. The best measure of economic growth is the gross domestic product (GDP). The **gross domestic product** measures the value of all goods and services produced by a nation during a specified period. The real GDP is the GDP adjusted for inflation.

The GDP includes the following:

- *personal consumption expenditures*—consumer spending
- *gross private domestic investment*—money businesses invest in buildings, equipment, technology, innovation, and inventory
- *net exports of goods and services*—the value of the goods and services exported minus the value of goods and services imported from other countries
- *government consumption expenditures and gross investment*—government spending

The U.S. Department of Commerce's Bureau of Economic Analysis (BEA) calculates the GDP each quarter. The growth or decline in production is measured by the change in the real GDP from one quarter to the next. Although the GDP is calculated quarterly, it is expressed as an annual rate.

For example, the chart in 2-3 shows the GDP figures from the first quarter of 2007 until the second quarter of 2009. The drop in GDP at the end of 2008 reflects the severe economic problems the U.S. was experiencing. At the end of 2008, GDP decreased at an annual rate of 6.3 percent. This was the largest drop in GDP in a quarter century.

A falling GDP indicates a weakening economy. When the GDP declines for two or more consecutive quarters, the economy is said to be in recession. A rising GDP indicates economic growth, or the beginning of a recovery from recession. An unexpected spurt in GDP may indicate that the economy is overheating and inflation could result.

Gross Domestic Product (billions of dollars) Seasonally adjusted at annual rates		
Year	Quarter	GDP
2007	1	13,795.60
	2	13,997.20
	3	14,179.90
	4	14,337.90
2008	1	14,373.90
	2	14,497.80
	3	14,546.70
	4	14,347.30
2009	1	14,178.00
	2	14,143.30

U.S. Bureau of Economic Analysis—Rev. 8/27/09

2-3

The GDP is shown in billions of dollars. Note the drop in GDP starting in the fourth quarter of 2008.

Consumer Price Index

The **consumer price index (CPI)** measures the movement of prices. It is a measure of the average change in prices over time for selected goods and services. It sometimes is called the "cost of living index." The CPI measures price changes for a bundle of goods and services purchased by average consumers against the prices for the same goods and services in a base period.

Here is how it works. The base period, which is 1982 through 1984, has an index number of 100. Price movements are stated as a percentage change from that index number. For example, the August 2008 CPI for all items was 214.46. This means $2.14 was needed in 2008 to buy what would have cost $1.00 in 1983.

The CPI measures price changes by collecting data from over 57,000 households and 19,000 establishments in 85 areas across the country. A weakness in the CPI is that it does not include real estate prices, income tax and other taxes, or social security paid by individuals and businesses. These expenses represent some of the greatest price increases for consumers.

The CPI is used to measure cost of living changes and to adjust wages for workers who are covered by *collective bargaining* agreements. These are contracts between employers and labor unions. A **labor union** is a group of workers who unite to negotiate with employers over issues such as pay, health care, and working conditions. CPI is also used to determine increases in social security and pension benefits to reflect cost of living increases.

Linking to... History

Adam Smith and John Maynard Keynes

Two economists instrumental in shaping modern economics were Adam Smith (1723-1790) and John Maynard Keynes (1883-1946). The ideas of Smith and Keynes continue to foster debate about the role of government in the economy today.

Adam Smith lived at the dawn of the industrial revolution. Previously, most people lived in rural areas and produced most of what they needed themselves. The industrial revolution brought people to cities to work in factories. Factory workers became part of an assembly line, each specializing in a small task that contributed to a finished product.

In his book, *The Wealth of Nations,* Smith hailed specialization, or *division of labor,* that created greater economic efficiency, mass production, and markets for goods. He argued that a free market economic system was superior to other systems because it harnessed a powerful force that motivated people: self-interest. In a free market economy, people have the freedom to do what is best for themselves and wind up doing what is best for the economy.

For example, in order to maximize profits, producers avoid wasting resources. To increase earnings, workers learn new skills. This give and take between people acting in their own self-interest is the "invisible hand" that runs the economy. Smith opposed government interference in the economy.

John Maynard Keynes witnessed WWI and the Great Depression. He and others saw the depression as a failure of Smith's "invisible hand" theory. The economy was damaged and only government intervention saved it. New government programs created jobs and stimulated the economy. Spending on WWII created new demand that finally lifted the U.S. out of the depression.

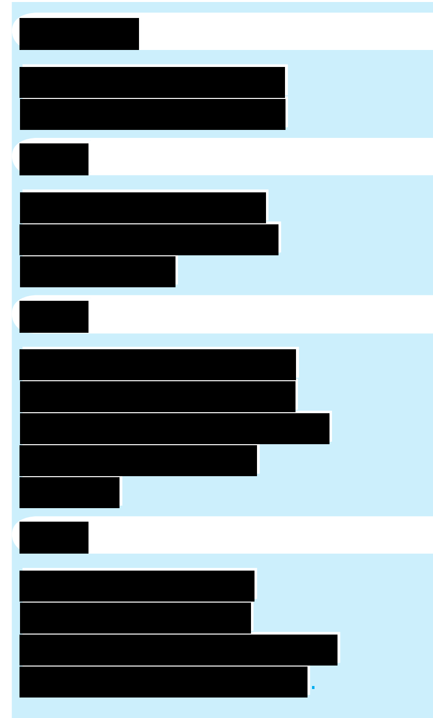
In his book, *The General Theory of Employment, Interest, and Money,* Keynes argued that economic stability and prosperity depends on government playing a role in the economy.

Fiscal Policy During Periods of Recession and Inflation

As mentioned earlier, a recession is a period of slowing economic activity. Overall economic activity declines. To stimulate demand for goods and services during a recession, government takes actions to increase the amount of money in circulation. With more money available, economic activity tends to expand. Government may increase spending to stimulate the economy. It may also lower taxes to leave more money for consumers and businesses to spend, which also increases demand. Businesses expand to meet the increased demand. Economic growth and expansion results.

Inflation occurs when demand is greater than supply. Increased demand drives up the prices of limited supplies. To combat inflation, government may increase taxes and reduce its own spending. This takes money out of circulation, reduces demand, and slows economic activity. Such action should help control inflation and bring prices down.

Monetary Policy



Monetary policy refers to actions the *Federal Reserve Board* takes to change the supply of money and credit. The *Federal Reserve Board* is part of the **Federal Reserve System**, also called the *Fed*. Created by Congress in 1913, this system is comprised of the Board, 12 Federal Reserve Banks, and the Federal Open Market Committee. The Fed regulates the nation's money supply and banking system. It uses the following three tools to manage the supply of money and credit.

Reserve Requirements

The level of reserves mandated by the Fed is the cash that banks and other financial institutions must set aside rather than lend to customers. It is expressed as a percent of their deposits. For example, suppose the reserve requirement is 10 percent. A bank that has $10 million in deposits from its customers can only lend $9 million. The other million must stay on deposit. High reserve requirements reduce the amount of money available for lending. As a result, the supply of money and credit falls. Low reserve requirements have the opposite results.

Discount Rate

The *discount rate* is the interest rate Federal Reserve Banks charge commercial banks for credit when they borrow. This affects the rates that banks charge consumers and businesses. A high discount rate discourages bank borrowing and reduces lending activities. This lowers the amount of money in circulation. Low discount rates have the opposite effect. One of the first steps the Fed takes to address an economic slowdown is to lower the discount rate. This makes credit available at a lower cost and permits businesses to expand and consumers to buy more goods and services. In periods of inflation the Fed is likely to increase the discount rate.

Open Market Operations

Open market operations refer to the Fed's buying or selling of Treasury securities in the marketplace. Treasury securities are debt obligations of the U.S. Treasury that include treasury bonds, notes, and bills. When the Fed buys these securities it increases the money supply. When the Fed sells government securities, the money supply shrinks because the dollars paid for these securities are no longer in circulation.

Easy Versus Tight Money

When the Fed follows an "easy" monetary policy, money and credit are readily available. Interest rates are relatively low. Under these conditions, consumers and businesses tend to spend. They buy or build more homes when interest rates for home mortgages are lower. Companies borrow more money for expanding their businesses. Entrepreneurs borrow

money to start new businesses. Farmers borrow to buy machinery and land to produce more crops. All of these activities stimulate the economy and create jobs. However, if too much money is pumped into the economy through Federal Reserve policies, inflation may result.

In times of inflation, the Fed turns to "tight" monetary policy. It increases reserve requirements, raises the discount rate, and sells government securities. These actions reduce the money supply and discourage the use of credit. As economic activity slows, price increases tend to level off or fall.

It may sound simple for the Fed to speed up or slow down the economy, but maintaining a balance between supply and demand is no easy task. All the parts in the puzzle are constantly changing. When facing stagflation, the Fed's job becomes even more challenging. If it tightens the money supply, which is the sure cure for inflation, it risks further slowing the already depressed economy. In addition, it can take months for monetary policies to bring about the desired changes. Finding the right balance and the right timing is critical and complicated. Government policymakers must be extremely careful in wielding their power.

Sometimes the government enacts policies that make a bad situation worse. For example, during part of the 1930s, the government followed a tight monetary policy. Some economists say this policy may have led to a deepening of economic troubles that became the Great Depression. The Depression did not end until the government pumped millions of dollars into the economy through a vast jobs program. The entry of the U.S. into World War II boosted demand for military weapons, uniforms, machinery, and many other goods and services that created jobs and economic growth.

Overall, government fiscal and monetary policies moderate the ups and downs in the business cycle. The government's goal is to create longer periods of prosperity with less severe downturns and upswings in the economy. The government's attempts to control recession and inflation are outlined in 2-4.

Taxing and Spending

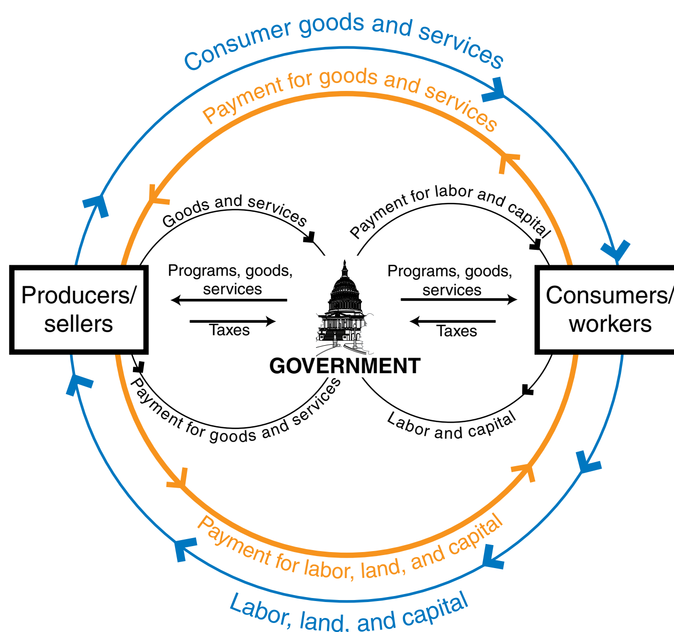
Government taxing and spending decisions make a significant impact on the overall economy. These decisions determine the amount of taxes individuals and businesses will pay. The decisions also determine the services that government will provide in return.

The circular flow diagram of the economy in 2-5 is similar to one presented in the previous chapter. However, this diagram incorporates the government's role. The inner circles, in black, show how government participates in the flow of goods and services as well as money. Producers/sellers provide goods and services to government and receive payment in return. Consumers/workers provide labor and capital for government and receive payment in return. Producers/sellers and consumers/workers receive programs, goods, and services from government for which they pay taxes. A **tax** is a fee imposed by government on income, products, or activities, and paid by citizens and businesses.

Fiscal and Monetary Policies			
Economic Conditions	**Likely Fiscal Policy**	**Likely Monetary Policy**	**Expected Results**
Inflation– A period of rising prices.	• Increase tax rates leaving consumers and business less to spend. • Reduce government spending to cut the amount of cash flowing into the system.	• Raise reserve requirements, so less money and less credit are available. • Increase the discount rate, making credit more expensive. • Sell government securities, drawing money out of circulation.	• Lower credit availability. • Less money in circulation. • Reduced spending. • Lower demand. • Falling production. • Slowing economy.
Recession– A period of economic slowdown and unemployment.	• Lower taxes, giving consumers and businesses more money to spend. • Increase government spending to pump more money into the economy.	• Lower reserve requirements, permitting banks to lend more money. • Lower the discount rate, making credit more affordable. • Buy government securities, pumping money into the economy.	• Increase availability of money and credit, which increases spending, which increases demand, which increases production, which leads to business expansion and jobs.

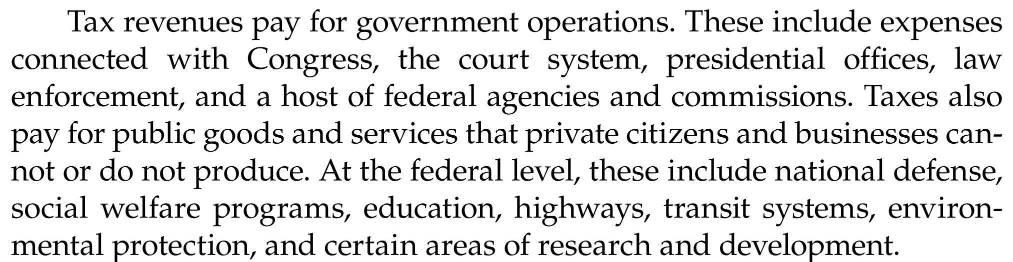
2-4

The government uses fiscal and monetary policies to alter economic conditions.



2-5

A circular flow of goods, services, and money takes place within the economy. This chart shows how government participates.



Tax revenues pay for government operations. These include expenses connected with Congress, the court system, presidential offices, law enforcement, and a host of federal agencies and commissions. Taxes also pay for public goods and services that private citizens and businesses cannot or do not produce. At the federal level, these include national defense, social welfare programs, education, highways, transit systems, environmental protection, and certain areas of research and development.

At the local and state levels, tax revenues pay for government operations and for public goods and services closer to home. These include schools, libraries, hospitals, roads, airports, parks, and fire and police protection. Citizens and businesses "buy" these goods and services from government with tax dollars.

Government spending of tax revenues creates demand for goods and services. For example, government pays for public schools with tax dollars. Private contractors build the schools with materials produced by private industries. This spending feeds money into the system, creates demand for goods and services, sparks business activity, and creates jobs.

During periods of inflation, government spending has a negative impact on the economy. It increases demand in the marketplace. When the combined demands of government and consumers are greater than the economy's capacity to produce, prices go up. This is why reductions in government spending help fight inflation by reducing demand.

Redistribution of Income

When government chooses to tax those who have more money to provide for those who have less, it redistributes income. One way to achieve this goal is through a *progressive tax*. This means those with higher incomes pay a higher rate of tax than those with lower incomes. The federal income tax system is progressive.

The government redistributes income through *transfer payments.* Transfer payments include income and benefits that the government provides for individuals and households in the form of social programs. The three most prominent programs are Social Security, unemployment compensation, and Temporary Assistance to Needy Families (TANF). These benefits are paid largely by taxing those who do not receive them.

A *subsidy* is a form of transfer payment that gives financial assistance to a business or entity, such as the arts, education, or health care. It may come in the form of a direct payment, a tax benefit, or some other advantage. The government pays billions of dollars in subsidies each year. The principal goal of subsidies is to benefit the public in some way.

For example, government may subsidize small farmers so they can compete with corporate-owned farms. A subsidy paid to milk producers guarantees them a reasonable profit and ensures a supply of milk for consumers. Many farmers who grow subsidized crops—including corn, wheat, cotton, soybeans, and rice—also get checks from the government. The flow of money in these cases is from taxpayers to those receiving the payments.

Deficit Spending and the National Debt

Often the cost of government programs and services is greater than the tax revenues it collects. Just as consumers borrow or use credit to pay their bills, the government borrows money to cover its expenses. The money is raised by the sale of Treasury and savings bonds to individuals, companies, and foreign countries.

Deficit spending is the amount the federal government spends each year beyond the amount it receives in revenues. When the government receives more than it spends, it is called a *surplus*.

Over the years, deficit spending and government borrowing have created a huge debt. Each year's deficit increases this debt. The **national debt** is the total amount of money the government owes at a given time. Like consumers, the government must pay interest, or fees, to borrow money.

The money paid in debt interest leaves less to pay for health care, education, environmental protection, defense, or other needs. When government borrows excessively, there is less credit available for business expansion, home mortgages, and other business and consumer needs. Dollars spent by government are dollars that are not available to the private sector where growth generally is created.

You and other taxpayers end up paying for the debt. As government spending and debt increase, revenues and taxes must also increase. High levels of government spending and national debt threaten future economic growth and represent a huge burden on future generations.

It is critical to keep a healthy balance between government participation and private enterprise if the U.S. economy is to stay a free market economy.

ECONOMICS in ACTION

The National Debt

In 2008, total federal, state, and local government spending came to more than 36 percent of GDP. The interest on this debt was one of the largest expense items in the federal budget. It came to approximately $261 billion or 9 percent of the federal budget. This amount was three times more than the amount spent on education, training, and employment.

After 2008, the deficit soared much higher. In 2009, the Congressional Budget Office predicted the deficit would be more than $1.8 trillion. The office predicted annual deficits of more than $1 trillion for years to come.

A growing national debt burdens both government and citizens. Eventually, taxpayers must pay for the debt.

Government Regulations

Almost every phase of business and economic activity falls under some form of government regulation. For instance, the simple hamburger sold across the nation is subject to thousands of local, state, and federal regulations. Rules cover everything—fat content of the meat, ingredients in the ketchup, advertising slogans, hiring practices, wages, restaurant inspections, disposal of trash, etc.

The earliest regulations were drafted mainly to promote fair competition and to ensure public well-being and safety. The regulations focused on preventing practices that interfered with fair competition. They were also aimed at protecting consumers from unfair and possibly harmful practices in the marketplace.

Fair Competition

Free competition is one of the hallmarks of a market economy. It works best when there are many sellers offering similar products. Competition between producers results in greater innovation, better service, and lower prices for consumers. It also results in the most efficient allocation of resources for the economy. This type of market structure is called **perfect competition**. It exists as a goal but is never fully achieved.

The opposite of perfect competition is monopoly. **Monopoly** refers to a single seller or producer of a given product or service. Since it has no competition, a monopoly business can charge high prices. There is little incentive to improve production efficiency or the products and services themselves.

Another threat to perfect competition is oligopoly. **Oligopoly** occurs when a few large companies dominate an industry. Oligopolies today include the music, communications, and automobile industries, among others.

The *antitrust laws* were passed to promote competition and fair trade and to prevent trade restraints in the marketplace. The best-known antitrust laws are

- The *Sherman Antitrust Act of 1890* prohibiting monopolies.
- The *Clayton Antitrust Act of 1914* prohibiting price fixing and other unfair trade practices.
- The *Federal Trade Commission Act of 1914* creating the Federal Trade Commission. This commission was given the power to investigate unfair or deceptive trade practices and to enforce compliance with lawful practices.

Although monopoly is illegal, exceptions have been made for some industries. For example, cable television companies were allowed to monopolize cable service in particular areas. It was impractical to have two or more companies rigging wires and cables throughout a community. Also when a drug company develops a new product, it becomes the sole provider of the drug for a period of time. During this period of no

competition, the company earns high profits. In this way, it is reimbursed for the costly process of bringing a new drug to market.

Oligopoly is legal, but the companies in an oligopoly are not allowed to make secret agreements among themselves. This is called **collusion**. Companies often collude to shut out smaller competitors and to engage in *price fixing*. Price fixing occurs when two or more businesses in an industry agree to sell at a set price and eliminate competition.

The Public's Well-being and Safety

In 1906 the Congress passed laws regulating the labeling of food and drugs and to ensure that meat was inspected before it could be sold. In 1913 the Federal Reserve System was established to oversee banking activities.

The Great Depression of the 1930s brought widespread unemployment and business failures. In response Congress passed new laws that increased government's power to intervene in the economy. New legislation provided for unemployment benefits, retirement income, and insured bank deposits. It also regulated the sale of securities and gave workers the right to form unions, 2-6.

Government involvement in the economy continues to grow. Today we have more than 100 regulatory agencies. Regulations that ensure public well-being and safety include laws in the areas of:

- equal opportunity
- fair labor practices
- workplace safety
- environmental protection

2-6
The National Labor Relations Act of 1935 gave workers the right to form unions. Unions help workers, such as assembly line employees, achieve fair wages and good working conditions.

Elected Representatives—State or Federal

Representatives are elected officials who serve as legislators at the state or federal level. They serve a leadership role in government by making decisions, analyzing government regulations and policies, and enacting new laws and regulations.

- pure foods, drugs, and cosmetics
- product safety
- truth in advertising and labeling
- truth in lending and saving

The Food and Drug Administration, the Environmental Protection Agency, the Consumer Product Safety Commission, and many other government agencies administer these regulations.

Costs of Regulation

Government regulations have a major impact on the economy. For example, every phase of the auto industry is regulated by government, from the manufacturer to your local service garage. Regulations cover working conditions, employee benefits, car warranties, auto servicing, registration and licensing, insurance, and advertising. Important and necessary as they are, federally mandated safety features, pollution controls, and fuel economy requirements add hundreds of dollars to the price of a new car.

Federal laws are passed by Congress in the U.S. Capitol, and signed into law by the President, 2-7. Regulations may be necessary to protect consumers and to ensure fair business practices. However, as the number of regulations and regulatory agencies increases, so does the cost to government, business, and ultimately consumers.

2-7

Legislators present bills to be enacted in the Capitol where they are voted upon by Congress and then presented to the President to be signed into law.

The scope of regulations and the paperwork required also add to the cost of regulating. Historically, government regulations were directed at a specific product or industry. Today, laws, such as the Occupational Safety and Health Act (OSHA) and the Consumer Product Safety Act (CPSA), apply to almost every existing business and product. Overall regulations also require more record keeping and paperwork than in the past.

Complying with government regulations is costly for businesses. Some question the wisdom of regulations that severely restrict industries from remaining competitive. In 2005 small firms with 20 or fewer employees paid an average annual cost of $7,647 per employee to comply with federal regulations. For larger businesses with 500 or more employees, compliance costs were $5,282 per employee. This does not include government expenses for enforcement and for the agencies created to enforce laws.

The impact of both inflation and recession is greater when excessive regulations cut into productivity and dramatically add to the cost of doing business.

Case Study: Government Regulation

Jake's Bread Factory

Jake worked for many years in a bakery. Eventually, he opened his own business. He baked high-quality breads and rolls. The business was successful and demand soared.

Jake wants to enlarge his plant, buy improved equipment, and hire more help to increase production. However, the expansion will make his business subject to more government regulations:

- Mandatory safety equipment and materials.
- Employee health and retirement benefits.
- New content and nutritional labeling.
- Packaging specifications.
- More inspections by the city health department.
- Additional and more detailed record keeping connected with these regulations.

Jake will have to raise prices to cover the costs associated with the additional regulations. If the demand for bread falls, the cost of meeting the regulations may become too high. He might be forced to close his business. If Jake decides not to expand, the jobs he would have created and the increased productivity will not benefit the economy.

Case Review

1. Regulations ensure Jake uses wholesome ingredients and is fair and honest with employees and customers. How much and what type of regulation do you feel is necessary to achieve these goals?
2. Some people argue for more regulations, stronger consumer protection, and broader government powers. How do you feel? What evidence can you find to support or oppose this position?
3. Critics of government regulations claim the cost is too high. They argue money spent to comply with regulations reduces the amount available for capital improvements. The cost is ultimately passed on to consumers in the form of higher prices. How do you feel? What evidence can you find to support or oppose your view?

Government Agencies Serving Consumers

Government agencies assist consumers by establishing and enforcing laws and regulations at the local, state, and federal levels. They protect consumers from unsafe products and unethical business practices. They represent consumer interests in many areas.

At the local and state levels, government agencies provide information, protection, and many other services. The agencies regulate food standards and sanitation practices, credit and insurance transactions, and business and trade practices. They also govern the licensing and certification of such groups as medical professionals, hospitals, nursing homes, funeral homes, lawyers, and others who serve the public.

Following is a list of several key federal government agencies with a brief description of their primary functions. All of these agencies have Web sites that fully describe their functions and services.

The ***Department of Agriculture (USDA)*** is one of the largest federal agencies. Its various departments and services relate to food production, economics, and international trade. In the interests of consumers, the USDA researches the nutrient content of food and ways to improve the quality and food safety of crops and livestock. It also provides food assistance to needy consumers and nutrition education to the public.

The ***Department of Energy (DOE)*** works toward a reliable, affordable, and clean energy supply for the nation. To achieve that goal, current programs focus on: biomass research and development, alternative energy sources such as wind and solar, and the potential of clean coal power. Other DOE priorities include the development of non-petroleum fuel sources for vehicles and better fuel economy, and more energy-efficient homes, appliances, and electronics.

The ***Department of Labor (DOL)*** promotes the welfare of wage earners, improves working conditions, and advances employment opportunities. This department enforces labor laws that include minimum wage, child labor, anti-discrimination, maximum working hours, and safety and health regulations. It also administers the Bureau of Labor Statistics and the Occupational Safety and Health Administration (OSHA).

The ***Department of Health and Human Services (HHS)*** serves the needs of citizens from birth to old age through a variety of programs and assistance. It administers financial aid programs, promotes public health, and works to control drug and alcohol abuse. HHS supervises and coordinates the work of many offices including the Centers for Medicare & Medicaid, the Office of Public Health and Science, the National Institutes of Health, the Centers for Disease Control and Prevention, and the Food and Drug Administration.

The ***Food and Drug Administration (FDA)*** protects the public against impure and unsafe foods, drugs, cosmetics, and other hazards. It operates national centers for drug evaluation and research, food safety and applied nutrition, and veterinary medicine.

The ***Social Security Administration (SSA)*** manages the federal government's retirement, survivors and disability insurance, and the supplemental security income programs.

The ***Department of Housing and Urban Development (HUD)*** supervises programs related to housing needs, fair housing opportunities, and

Occupational Health and Safety Specialists

Occupational health and safety specialists inspect workplaces and recommend ways to reduce and eliminate disease or injury. They look for biological, chemical, physical, and radiological hazards and identify ways to increase workers' safety. Specialists are employed by federal, state, and local government agencies.

community development. It administers mortgage insurance to promote home ownership, rental assistance for low- and moderate-income families, housing safety standards, urban renewal programs, and federal real estate laws.

The ***Consumer Product Safety Commission (CPSC)*** protects the public against risk of injury from consumer and children's products, 2-8. It sets safety standards for products and researches the causes and prevention of product-related injuries and deaths.

The ***Federal Trade Commission (FTC)*** promotes free and fair competition by preventing deceptive practices, false advertising, and unfair trade practices in the marketplace. It enforces consumer protection legislation in a variety of areas including consumer credit transactions, packaging and labeling, product warranties, and truth in advertising.

The ***Securities and Exchange Commission (SEC)*** enforces fair and full disclosure of financial data about securities being offered for sale. The SEC also protects investors against fraud when buying or selling securities. It regulates security exchanges and associations, investment companies, brokers, dealers, and investment counselors.

The ***U.S. Department of the Treasury*** manages the finances of the federal government. It collects taxes and other payments that are owed to the government. It pays the nation's bills, borrows money if necessary, prints and distributes currency, regulates national banks, guards the country's gold and silver, and investigates financial crimes and crimes involving the use and distribution of alcohol and tobacco.

The ***Federal Communications Commission (FCC)*** regulates communications by telephone, television, radio, cable, wire, and satellite.

Specific Laws Protecting Consumers

In addition to the many agencies that serve and protect consumers, a host of federal, state, and local laws addresses consumer protection. A few of the many federal laws that protect you and all consumers in the marketplace include:

- Product Packaging Protection Act of 2002
- Fair and Accurate Credit Transactions Act of 2003
- Food Allergen Labeling and Consumer Protection Act of 2004
- Bankruptcy Abuse Prevention and Consumer Protection Act of 2005
- Dietary Supplement and Nonprescription Drug Consumer Protection Act of 2006

2-8
The Consumer Product Safety Commission provides recall information and safety alerts for children's products, such as infant car seats.

With all this government protection and regulation, abuses and unfair play still exist in the marketplace, though they are not the rule. Most businesses, like most people, want to do the right thing. Still, new ways to work the system with advantages to the seller at the expense of the consumer will continue to surface. When you enter the marketplace, be prepared to use your best judgment.

Chapter Summary

In our economic system, the most fundamental role of government is to provide the legal and institutional environment and the economic policies that permit and encourage productive economic activity. The system is based on the rule of law and leads to political and economic stability. This is what gives businesses and individual citizens the confidence to enter the marketplace as producers, workers, and consumers.

Government also plays other important roles in the economy. It controls the money supply and levies taxes to pay for government operations and public services. These fiscal and monetary policies keep our economy stable and prosperous. Government enacts legislation to promote open and fair competition and to protect consumer interests in the marketplace.

Government protects your consumer interests and rights in countless ways. Specific laws cover almost every possible type of consumer product and transaction. Government agencies and departments serve and protect consumers at federal, state, and local levels. Laws and regulations cover everything from the purity of your food and water, to the air you breathe, and the money you borrow. As a consumer, you will want to be aware of the laws that protect your interests and the government agencies serving you.

Review

1. What is government's fundamental role in a free market economy?
2. Name three other functions of government in our economy.
3. Name and describe the four parts of the business cycle.
4. Name three signals of a recession.
5. How does inflation hurt consumers and businesses?
6. What is stagflation?
7. Name and describe three types of unemployment.
8. List three consequences of rising unemployment and underemployment rates to families.
9. What is fiscal policy and how can it be used to stimulate or slow down the economy?
10. What is monetary policy and how can it be used to stimulate or slow down the economy?
11. Name three ways national debt hurts the economy.
12. What is the purpose of antitrust laws?
13. Name six government departments or agencies that serve and protect consumers.

Critical Thinking

14. How can too much government interference in the economy have a negative impact? What is too much? What is necessary?

regulate

ity.

15. In your state, how much sales tax do you pay for every dollar you spend? How does the government use this money?
16. What choices has your community made in recent years in the use of public funds or tax revenues to meet public needs and wants for such services as education, police protection, street repairs, parks, and recreation?
17. What public goods do you and your family routinely use and enjoy?
18. How do laws that prohibit monopolies protect the consumer's right to choose?
19. What are the costs of regulation for government and for business and in what way do consumers pay these costs?
20. What has been your experience with consumer protection agencies and laws?

Academic Connections

21. **Reading.** Read the business section of *The Wall Street Journal* or another major newspaper for one week and summarize the financial and economic state of the economy.
22. **Social studies.** Make an appointment to visit a local government official of your village, city, or county. Find out how local taxes are assessed in your community and what services they provide. Summarize your findings for the class.
23. **History.** Some Americans are strongly opposed to almost any government intervention in the economy. How did they view the enlarged role of the government during the economic crisis that began in the fall of 2008? Research the press coverage at that time and share your findings with your class.
24. **Social studies, writing.** Many people believe that media oligopolies threaten American democracy. Do a few large companies control the newspapers, radio and television stations, and publishing houses in your community? Do some research to either confirm or deny this and write an article for the school or local newspaper.

Math Challenge

25. This chapter uses graphs to present statistical information. A graph is used to depict the unemployment rate over time. A line graph shows fluctuations in the business cycle over time. For each of the following, state what type of chart would best express the information.
    A. Show fluctuations in the rate of inflation over the past 25 years.
    B. Show the proportion of new U.S. citizens who came from each of the world's continents.
    C. Show total taxes collected by the federal government during the past 10 years.

Tech Smart

26. Use the Internet to find the current U.S. unemployment rate, GDP, CPI, and Federal Reserve discount rates. Cite your sources.