# The U.S. Economy: Private and Public Sectors


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**Households as Income Receivers**

- Functional distribution of income is shown in Figure 5-1.(This figure is based on NI-National Income.)
  - Wages and salaries are 70 percent of total.
  - Proprietors' income (income to self-employed business owners, doctors, lawyers, etc.) is under 10 percent of total.(This is a combination of wage and profit income.)
  - Capitalist income-corporation profits, rent, interest-is less than one-fifth of total.(Note: rent may be negative because of the depreciation charged against rental income.)
- Personal distribution of income is shown in Figure 5-2.(This figure is based on PI-Personal Income.)
  - It is often described by dividing the population into quintiles or five numerically equal parts.
  - Proportions of total income going to each quintile are then compared.
  - Comparison shows unequal distribution of income.For example, see how many times greater the share of income going to the top quintile is relative to the bottom fifth.(Key Question 2)

**Households As Spenders (Figure 5-3) (Figure is based on PI-Personal Income)**

- Use Figure 5.3 or most recent data from Survey of Current Business, January issue of current year, to describe the following.
- How do households dispose of their income?
  - Personal taxes, of which Federal personal income tax is the major component, has increased over the years.

    - Saving (dissaving if spending exceeds income) is the smallest fraction of personal income disposition.
    - Most of household income goes to consumer spending (Figure 5.3).There are several categories of spending categories (Figure 5.4):
        - Durable goods are those with life of three or more years.
        - Nondurable goods include things such as food and clothing.
        - Services are today more than one-half of all consumer spending, which demonstrates that ours is a service-oriented economy.

**The Business Population**

- Related definitions:
    - Plant:physical establishment where production or distribution takes place (factory, farm, store).
    - Firm:business organization that owns and operates the plants.(The legal entity.)
    - Industry: a group of related firms, producing the same or similar products.
        - Examples include the automobile industry or the tobacco industry.
        - Confusion often occurs because many businesses are multiproduct firms.
    - Types of multiplant firms:
        - Horizontal integrated: a multiplant firm with plants in the same stage, like a retail chain store such as J. C. Penney or Safeway.
        - Vertical integrated: a multiplant firm in which the company owns plants at different production stages. Example: A steel company may own ore and coal mines as well as different plants in different stages of the manufacturing process.
        - Conglomerate: a firm that owns plants in different industries or markets.

- Legal forms of businesses(Figure 5.5):
    - Definition:
        - Sole proprietorship: a business owned by a single individual.
        - Partnership: two or more individuals own and operate the business in a partnership agreement.
        - Corporation: a legal entity distinct from its individual owners. The organization acts as "legal person."
    - Discussion of Figure 5-5 relative to most important - percentage of firms versus percentage of sales.
    - Sole proprietorship
        - Advantages: easy to set up; proprietor is his/her own boss; because profit is proprietor's income, there is an incentive to operate the business efficiently.
        - Disadvantages: financial resources are limited and insufficient; the proprietor is responsible for all of management functions; the proprietor is subject to unlimited liability.
    - Partnership
        - Advantages: easy to organize; greater specialization; better access to financial resources than proprietorships.

        - Disadvantages: some of the same shortcomings of the proprietorship; possible difficulties in sharing management responsibilities; still limited financial resources; problems if one of the partners leaves; still unlimited liabilities.
    - Corporations
        - Advantages: improved ability to raise financial capital (money); defining and comparing stocks and bonds; limited liabilities; corporations have a permanence that is conducive to long-run planning and growth.
        - Disadvantages: red tape and expense in obtaining a corporate charter; unscrupulous business owners sometimes avoid responsibility for questionable business activities.
    - Hybrid structures
    - Principle-agent problem

**The Public Sector: Government's Role**

- Providing the legal structure:
    - Government ensures property rights, provides enforcement of contracts, acts as a referee and imposes penalties for foul play.
    - Government intervention improves the allocation of resources by supplying a medium of exchange, ensuring product quality, defining ownership rights, and enforcing contracts.
    - These interventions widen the market and foster greater specialization in the use of property and human resources.
    - The appropriate amount of regulation is at the level where the marginal benefit and marginal cost are equal.
- Maintain competition:
    - Competition is the market mechanism that encourages producers and resource suppliers to respond to consumer sovereignty.
    - If producers (and/or resource suppliers) have monopoly power, the monopolist can charge higher-than-competitive prices and supplant consumer sovereignty with producer sovereignty (or economic rent).
    - If "natural monopoly" exists, government regulates price and service.(Natural monopoly exists when technology or economic realities make a monopoly more efficient than competition.)
    - Where competitive markets are more efficient, anti-monopoly laws (Sherman Act of 1890; Clayton Act of 1913) are designed to regulate business behavior and promote competition.
- Redistribution of income:
    - Transfer payments provide relief to the poor, dependent, handicapped, and unemployment compensation to those unemployed who qualify for benefits.Social Security and Medicare programs support the sick and aged.
    - Government intervenes in markets by modifying prices.Price support programs for farmers; minimum wage laws are examples.
    - Taxation takes a larger proportion of incomes of the rich than the poor.
- Reallocation of resources:

- Market failure occurs when the competitive market system produces the "wrong" amounts of certain goods or services or fails to provide any at all.
- Spillovers and externalities
  - Spillovers or externalities occur when some of the benefits or costs of production are not fully reflected in market demand or supply schedules. Some of the benefits or costs of a good may "spill over" to third parties.
  - An example of a spillover cost is pollution, which allows polluters to enjoy lower production costs because the firm is passing along the cost of pollution damage or cleanup to society. Because the firm does not bear the entire cost, it will overallocate resources.
  - Correcting for spillover costs requires that government get producers to internalize these costs.
- Legislation can limit or prohibit pollution, which means the producer must bear costs of antipollution effort.
- Specific taxes on the amounts of pollution can be assessed, which causes the firm to cut back on pollution as well as provide funds for government cleanup.
  - Spillover benefits occur when direct consumption by some individuals impacts third parties. Public health vaccinations and education are two examples. Because some of the benefits accrue to others, individuals will demand too little for themselves and resources will be underallocated by the market.
  - Correcting for spillover benefits requires that the government somehow increase demand to increase benefits to socially desirable amounts.
- Government can increase demand by providing subsidies like food stamps and education grants to subsidize consumers.
- Government can finance production of good or service such as public education or public health.
- Government can increase supply by subsidizing production, such as higher education, immunization programs, or public hospitals.
- Government provides public goods and quasi-public goods and services.
  - Private goods are produced through the market because they are divisible and come in units small enough to be afforded by individual buyers. Private goods are subject to the exclusion principle, the idea that those unable and unwilling to pay are excluded from the benefits of the product.
  - Public or social goods would not be produced through the market, because they are indivisible and are not subject to the exclusion principle.
- A lighthouse is a good example of a public good. The light is there for all to see whether or not they paid for it. Those who receive benefits without paying are part of the so-called free-rider problem.
- Other examples include national defense, flood-control, public health.
  - Producers would not be able to find enough paying buyers for "public goods" because of the free-rider problem mentioned above. Therefore, "public goods" are not produced voluntarily through the market but must be provided by the public sector and financed by compulsory taxes.

        - Quasi-public goods are those that have large spillover benefits, so government will sponsor their provision. Otherwise, they would be underproduced. Medical care, education, and public housing are examples.
        - Resources are reallocated from private to public use by levying taxes on households and businesses, thus reducing their purchasing power and using the proceeds to purchase public and quasi-public goods. This can bring about a significant change in the composition of the economy's total output.

- Promoting stability:
    - An economy's level of output is dependent on its level of total spending relative to its productive capacity.
    - The government may promote macroeconomic stability through changes in government spending and taxation.
        - When total spending is too low, the government may increase its spending and/or lower taxes to reduce unemployment.
        - When total spending is excessive, the government may cut its spending and/or raise taxes to foster price stability.

**Circular Flow Revisited**

- Figure 5.6 shows the circular flow model with the addition of the government sector.
- There are several modifications to the Chapter 2 model.
    - Flows (5) through (8) illustrate that government makes purchases and expenditures in both the product and resource markets.
    - Flows (9) and (10) illustrate that the government provides public good and services to households and businesses.
    - Flows (11) and (12) illustrate that government receives taxes from and distributes subsidies to households and businesses.
- These flows suggest ways that the government might alter the distribution of income, reallocate resources, and change the level of economic activity.

**Government Finance**

- Government expenditures on goods and services and transfer payments.
    - Government purchases directly use or employ resources to produce goods or services measured in domestic output.
    - Government transfer payments are not directly part of domestic output, but include payments like social security, unemployment compensation, welfare payments.
- Changes in government purchases of goods and services, expenditures on transfer payments, and total spending as percentages of U.S. output, 1960 and 2000 (Figure 5.7).
- Major growth in government spending since the 1960s has been in transfer payment area.

**Federal Finance (see Figure 5.8)**

- Expenditures emphasize four important areas.
  - Income security,
  - National defense,
  - Health, and
  - Interest on national debt.
- Receipts come from several sources.
  - Personal income tax is a major source.
    - The Federal personal income tax is progressive. People with higher incomes pay a higher percentage of that income as tax than do people with lower incomes.
    - A marginal tax rate is the rate at which the tax is paid on each additional unit of taxable income (Table 5.1).
    - The average tax rate is the total tax paid divided by total taxable income.
    - A tax whose average tax rises as income increases is progressive.
  - Payroll taxes, such as social security contributions, are a close second as source of revenue.
  - Corporate income taxes on corporation profits are the third largest source of revenue.
  - Excise taxes are similar to sales taxes on specific commodities, like alcoholic beverages, tobacco, and gasoline. They are levied at the wholesale level, so are hidden from the consumer.
  - Global Perspective 5-2 shows that Australia, the United States, and Japan enjoy relatively low tax burdens.

**State and Local Finance**

- State expenditures and receipts for all states in 1998 are illustrated in Figure 5.9.
  - State revenues primarily come from sales taxes and secondly from personal income taxes.
  - State spending goes for public welfare, education, highways, and health care.
- Local expenditures and receipts for all local governmental units in 1996 are shown in Figure 5.10.
  - Revenue is primarily from property taxes.
  - Spending is primarily on education.
  - Gap between local tax revenues and spending is largely filled by grants from state and Federal government.(This system of intergovernmental transfers is called fiscal federalism.)

**LAST WORD: The Financing of Corporate Activity**

- A major advantage of corporate form of organization is the ability to finance operations through sale of stock and bonds.This Last Word examines corporate finance in more detail.
- There are three ways to finance corporate activity:
  - Internally out of undistributed profits,
  - Borrowing from financial institutions, and

- Issuing stocks and/or bonds.
    - Common stock is a share of ownership in the corporation and gives the holder a voting right and share of dividends.
    - A bond is an IOU whereby the corporation promises to pay the holder a fixed amount in the future plus annual interest.

- Differences between stocks and bonds:
  - Bondholder is not an owner, only a lender.
  - Bonds are less risky usually because of certain factors.
    - Bondholders can claim interest payments before stockholder dividends are calculated.
    - Interest is guaranteed as long as company is healthy, whereas dividends depend on profits.
  - Risks involved with bonds include:
    - Capital risk, which means that the market price of a bond can change if market interest rates change and a holder needs to sell a bond before its maturity date. Note that the market price of a bond varies inversely with market interest rates.
    - Risk of unexpected inflation means that the purchasing power of the bond will fall because its interest rate is less than the inflation rate.