Chapter 2

**The Economy: Myth and Reality**

Chapter 2 introduces students to some of the key characteristics of the U.S. economy. This chapter also defines the meaning of input and output, and how businesses, people, and the government interact in the economy. The chapter will help students refine some of what they already know, using economic language.

Chapter Outline

the american economy: a Thumbnail sketch

An economic system factors in production (inputs) to produce the goods and services that people, businesses, and the government buy (output). This output may be sold domestically, or to foreigners.

Outputs produced domestically (within the United States) and sold abroad are known as exports. Outputs produced abroad and sold domestically (in the United States) are known as imports.

Gross Domestic Product (GDP) is a measure of the economy’s output. The U.S. economy is the biggest national economy in the world.

The United States is primarily a private-enterprise economy.

Businesses, or private enterprises, produce most of U.S. economy’s output.

The United States is a relatively “closed” economy.

Most of the goods and services sold within the United States are produced within the U.S. economy. Most of the U.S. economy’s output is sold domestically.

The U.S. economy grows over time, but this growth is not steady.

GDP has grown over time, but the growth in GDP is not the same from year to year. The economy experiences business cycles—periods of recession and economic expansion.

THE INPUTS: LABOR AND CAPITAL

Workers participate in a variety of tasks in the U.S. economy. Like other industrialized countries, the U.S. economy employs more people in service-related industries.

Labor is the time and effort a person provides in the production of a good or service. Capital includes machines, equipment, and buildings used in the production of output.

National income measures how much is paid to the factors of production.

The wage is the payment a worker receives for his or her time. Wages account for the largest portion of all payments to factors of production.

The remainder of national income is paid to the owners of capital. These payments consist of corporate profits and interest.

the outputs: what does America produce?

Most of the output produced within the U.S. economy is sold to U.S. consumers. The remainder of output goes to nonconsumption uses, including those items purchased by the government and businesses.

the central role of business firms

Businesses hire people, purchase or rent capital, and oversee the production of the goods and services consumers want to buy.

Businesses compete with other firms within their industry. This leads to greater efficiency in the use of inputs.

what’s missing from the picture? government

The U.S. government plays many roles in the economy:

The government is a referee—it enforces laws and establishes order.

The government is a business regulator—it imposes restrictions on businesses on society’s behalf. For example, the government regulates monopolies and punishes businesses that pollute the environment.

Federal, state, and local government collect taxes to finance their expenditures. Some taxes are used to provide services (freeways, education, and other infrastructure); others are used to redistribute income through transfer payments and progressive taxation.

conCLusion: it’s a mixed economy

The U.S. economy includes both free-market and government-controlled sectors.

Margin Definitions

**Factors of Production or Inputs:** labor, machinery, buildings, and natural resources used to make outputs.

**Outputs:** goods and services that consumers and others want to acquire.

**Gross domestic product (GDP):** a measure of the size of the economy—the total amount it produces in a year.

**Open economy:** an economy in which exports and imports constitute a large share of GDP.

**Closed economy:** an economy in which exports and imports constitute a small share of GDP.

**Recession:** a period of time during which the total output of the economy falls.

**Transfer payments:** sums of money that certain individuals receive as outright grants from the government, rather than as payment for services rendered.

**Progressive tax:** a tax in which the ratio of tax to income rises as income rises.

**Mixed economy:** an economy with some public influence over the workings of free markets. There may also be some public ownership mixed in with private property.

Major Ideas

1. An economic system is made up of people, businesses, and the government. These three parties interact in a variety of ways through markets.

2. The key characteristics of the U.S. economy are the following:

a) The United States is a private-enterprise economy where most goods and services are exchanged in free markets.

b) The U.S. economy is relatively closed, as exports and imports account for a relatively small share of GDP.

c) The U.S. economy is growing over time, but this growth is not stable. The economy experiences businesses cycles—periods of economic recession and expansion.

3. Wages, payments to labor, account for the largest share of national income. Payments to capital (interest and profits) account for the remainder.

4. In addition to enforcing laws and regulation, federal, state, and local governments finance expenditures through collecting taxes. Some taxes are used to redistribute income through progressive taxation and transfer payments.

5. Like most nations, the United States is a mixed economy, with free-market and government-controlled components.

On Teaching the Chapter

The material in Chapter 2 shows students how an economic system works, highlighting the U.S. economy. It identifies how people, businesses, and the government participate in the economic system in several ways through inputs, outputs, and markets. This chapter helps the student to use the language of economics to explain everyday phenomena. Some instructors may prefer to skim over this material; others may prefer to cover it in more detail.

This chapter is likely to spark discussion and questions among the students because it reveals quantitative information about the structure of the U.S. economy. The instructor can demonstrate how statistics are used to explain features of the economy, highlighting the differences between dollars versus percentages, between individual versus economy-wide statistics, and in how to interpret different statistical diagrams in the text. This will not only help students in later chapters, but also in future courses and in deciphering information in the media.

Some students may find it difficult to comprehend large dollar figures, percentages, and graphs. This is why the groundwork from the Chapter 1 appendix is so important—interpreting statistical information makes use of these abstract mathematical tools. Bring in a graph from a newspaper and have the students answer some pointed questions in class. This will help them to interpret graphs without the use of the sidebars printed in the text.

In discussing the inputs and outputs sections of the chapter, differentiate between the microeconomic and macroeconomic issues. This will interest those students who’ve studied one or the other, and give students a preview of what they will learn in the course (and potentially future courses).

Finally, when covering the government’s role in the economy, it is useful to have a few other countries in mind as a benchmark: How does the U.S. government’s role compare to that of other countries?

Discussion Questions

Instructors who want to spend some time with this chapter can ask discussion questions that relate to any or all of the statistical information presented in the text. Students may be most interested in questions that come from today’s newspaper. The questions here elaborate on points mentioned in the text.

1. The U.S. economy is primarily a private-enterprise economy. What are some of the goods and services provided by the U.S. government? Why might the government provide these goods and services more effectively than a private business? What are some of the drawbacks to the government providing these goods and services?

Suggested Answer: National defense, law and order maintenance, free education, basic research, poverty-alleviation programs, health and public welfare programs, infrastructure, etc., are some of the services provided by the U.S. government. If these activities are left to private players, they will not produce the quantitydesired by society. The government can provide these goods and services more efficiently than private players. Students could discuss the efficiency and equity issue here while considering the drawbacks of the government in providing theses goods and services.

2. The text argues that the U.S. economy is relatively closed because imports and exports account for a relatively small share of U.S. production and spending. As trade becomes a larger share of U.S. production, how might this affect what is produced in the United States versus abroad? How might this affect the types of jobs American workers are employed in?

Suggested Answer: Students can discuss the advantages and disadvantages of free international trade. Share of export goods in the total goods produced will increase as trade becomes a larger share of U.S. production. At the same time, foreigners will produce those goods that Americans demand more. More employment opportunities will be created in the industries that produce goods and services for the export market. But there will be job losses in the import-competing industries in the United States. Related concepts: specialization, sustainable competitive advantage, technology.

3. What are the costs of economic recessions in both a microeconomic sense and a macroeconomic sense? How might recessions affect people employed in different types of jobs?

Suggested Answer: A recession may involve simultaneous declines in the overall economic activity such as employment, investment, and corporate profits in particular sectors of the economy or in the economy as a whole. It will reduce aggregate demand so the GDP of the country also reduces. Sectors affected by recession will face the loss of jobs. Related concepts: downsizing, outsourcing, depression.

4. Consider how different groups in the economy are employed in different jobs. Why might teenagers be employed in low-wage jobs? Why has the percentage of teenagers in the labor force declined since the mid-1970s?

Suggested Answer: The text section “The Inputs: Labor and Capital” provides some insights. Students can elaborate on factors that influence the demand for labor such as productivity, experience, and educational qualification. Most teenagers fill low-wage jobs at fast-food restaurants, amusement parks, and the like. Teenagers generally have not completed their educations and have little job experience, so their productivity tends to be relatively low. Relatively few can be found in the nation’s factories. Students can also discuss the factors that made labor under age 20 a scarce resource.

5. According to the text, unemployment is higher in Europe than it is in the United States. How might government policy influence the unemployment rate?

Suggested Answer: Students should discuss policies, especially fiscal policies, intended to combat unemployment. Unemployment is mainly due to lack of effective demand. The government can stimulate aggregate demand by increasing government expenditure or reducing taxes. Increase in aggregate demand will create new employment opportunities thereby reducing unemployment.

6. There are many different types of businesses that produce within the United States. With the increase in international trade and rise of multinational corporations, many of the finished products we buy are put together using parts and labor from many different countries. What makes a product an “American” product? Where it is actually produced? Or the labor that produces it? Where do the parts come from? Consider the information from “Is That an American Company?”

Suggested Answer: Students should discuss the integration of world economies in the era of globalization and multinational corporations, which are corporations that have their facilities and other assets in at least one country other than their home country. In this era of integration, it is difficult to define the nationality of a company and its products. In the globalized world, the production process of a product is done in different parts of the world. One product uses different components that are produced in different countries. Hence, in this globalized world, one cannot assign the origin of a product to any particular country.

7. The government plays many different roles in the economy. Which do you believe is most important to ensuring the economy functions well? Which is most important for ensuring the well-being of all individuals in society?

Suggested Answer: Analyze the section “What’s Missing from the Picture? Government.” Student answers will vary.

Problems

The Study Guide contains several excellent problems that can be used to reinforce the student’s understanding of graphs.