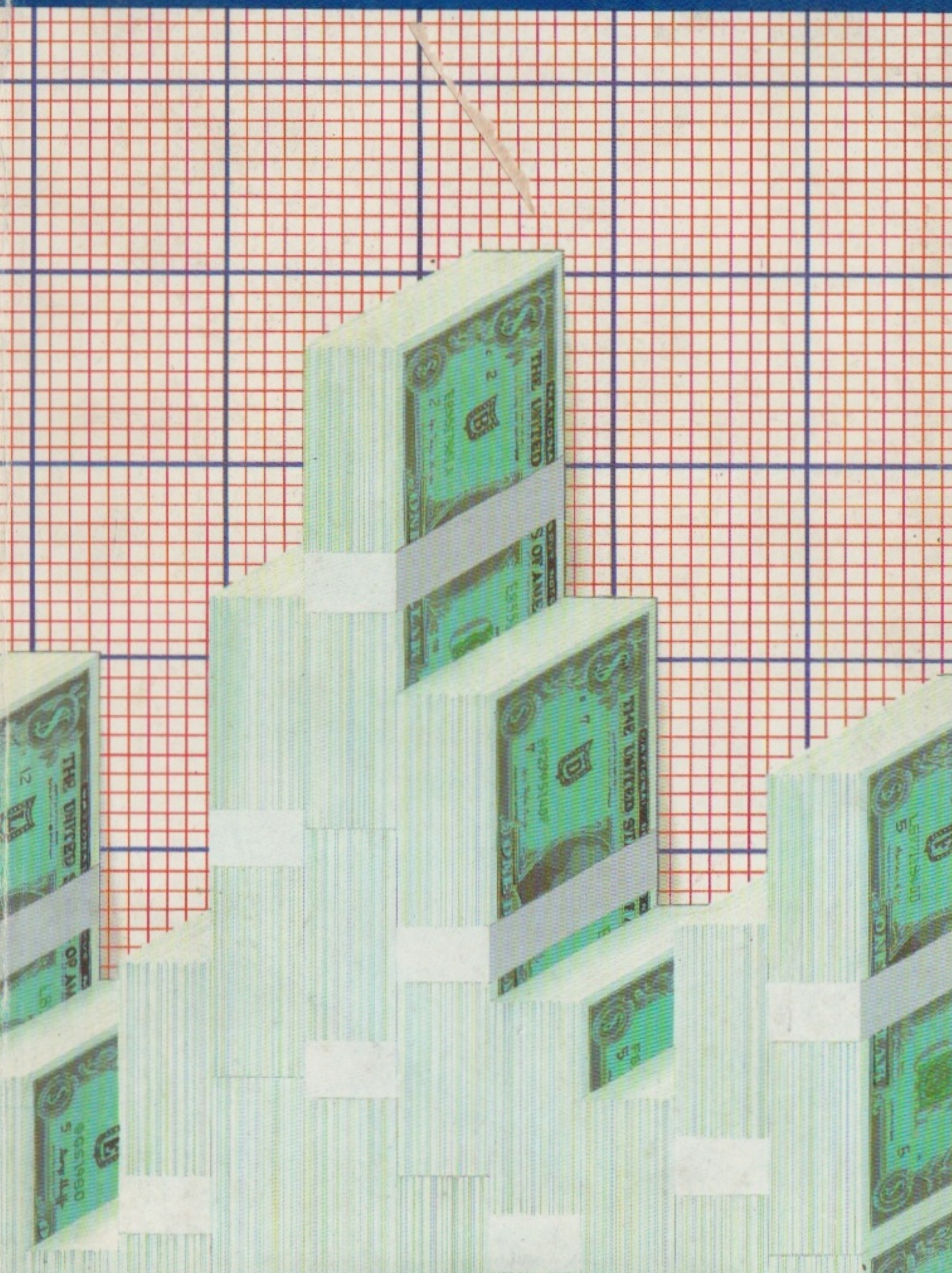
AN OUTLINE OF AMERICAN ECONOMICS



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INTRODUCTION

School children in the United States have traditionally been taught to sing:

O beautiful for spacious skies,
For amber waves of grain,
For purple mountain majesties
Above the fruited plain!
America! America!
God shed his grace on thee...

The emphasis on natural plenty is one of the dominant traditions in American history. Reference to God and piety is another American tradition—often seen as the arrogance of certainty about metaphysical matters. But there are other traditions or dominant themes in American history. These include America as a land of opportunity for its immigrant labor, the role of the frontier, and the emphasis on individual self-reliance (it was a very soft frontier, the American frontier, but soft or not, it called for individual courage and diligence). The song continues:

And crown thy good with brotherhood
From sea to shining sea.

Here the song departs from historic reality and goes on to assert a dream for the future, implying unity. One of the dominant themes in American history has been regional rivalry. The first chapter of this rivalry culminated in the election of a charismatic northern leader in 1860, Abraham Lincoln. Probably one of the most persuasive orators in the history of western civilization, Lincoln led the nation into a civil war and, as is so often the case, laid the foundations for reconciliation. Nonetheless, no Southerner (that is, a repre-

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sentative from the defeated, disaffected side) was elected President until 99 years after Lincoln's assassination.[1] And even then, the man elected in 1964 (Lyndon B. Johnson) had previously succeeded to the Presidency because of assassination (of John F. Kennedy). It can be said that the South regained its role of historical leadership only when Jimmy Carter was elected in 1976.

Nonetheless, regional rivalry continues to be characteristic of American political and economic development. Sometimes it is an alliance between the North and West against the South; at other times it is a regional alliance between the South and the West against the North. Most recently there is friction between the extreme West and the rest of the country. Within each of these regions there are rivalries between the urbanized population (which originally was only a small portion of the total) and the farm population (which is now only a small portion).

America is a massive country, generously endowed in natural resources, historically a land of economic and civil opportunity for Europeans and some Asians, and the land that has rediscovered in each generation its two principal colonial traditions: (1) the aggressive pietism and faith in the solution of social problems originally found in the Puritan colonies, principally Massachusetts, and (2) the individualism and emphasis on freedom and geographic mobility, particularly for whites, originally found in Virginia. This chapter simply sets the stage for receiving America's historic self-perception.

[1]Woodrow Wilson, elected President in 1912 and 1916, was Virginia-born but lived his adult life in the North. After serving as the president of Princeton University, he was elected governor of New Jersey.

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A HISTORICAL PERSPECTIVE ON THE AMERICAN ECONOMY

The English arrived in North America with hopes of duplicating the exploits of the Spanish in South America, where explorers had discovered immense fortunes in gold and silver. Although Spain and England shared a pronounced lust for wealth, differences between the two cultures were profound.

Catholic Spain had, by expelling its Jews and Moors, achieved the spiritual security of a united church. To the Spanish policy-makers, the New World was a place that offered Spaniards adventure, romance, and religious converts, while it offered to the Spanish crown a financial base for the Hapsburgs' European adventures.

England, unlike Spain, continued in the 16th and 17th centuries to be torn by political and religious disunity. Because of this English background of civil conflict, English-speaking America, where there were no religious wars, as such, is often described as a land of refuge to which men and women came in order to enjoy the religious and political freedom denied them in their homeland. This conception of America's beginnings in the 17th century is for the most part true. Most of those who came to settle the early colonies sought not adventure or romance, but a new homeland. Some came to express religious piety; others sought a free society. For example, the Puritans, a sizable percentage of the earliest settlers in Massachusetts (the principal area of settlement), were a pious, self-disciplined people, but they were almost as intolerant of others' views as were the people in England they viewed as having driven them out. Massachusetts was not amenable to those who did not share the majority's convictions about right and wrong, nor was it comfortable for those who were unwilling or unable to work. What is called by many "the Protestant ethic" was clearly descriptive of the dominant mood in prerevolutionary New England.

Erie Canal, connecting New York's Hudson River to Lake Erie, aided early economic growth of northeast United States.

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But settlers did not come to the New World solely because of motives of piety. Beginning with the Jamestown colony in 1607, charter companies founded colonies principally as business ventures. Yet that piety and profits were not necessarily at loggerheads. The Puritan settlement at Plymouth Plantation, although not organized with profits in mind, did not ignore economic considerations. Nonetheless, early attempts at substantial profits were largely failures, at least for the original English investors. There was little gold, and mining was not economical on the East Coast. As a result, land for farming had to be cleared, and even when the harvests were good, prices were modest (little money was available) and so profits tended to be small. Labor was in short supply, and real wages were much higher than they were in England. Both the Jamestown and the Plymouth colonies were quickly turned over by the original English investors to the settlers. The political implications were enormous; few Englishmen cared about the unprofitable colonies and left the colonials to build their own lives, their own communities, and their own economy.

The Colonial Economy

Most early prosperity resulted from trapping and trading in furs. In Massachusetts, the fishing industry was a primary source of colonists' wealth. Yet everywhere, colonists had to rely mainly on small farms and self-sufficiency. Households produced their own candles and soaps, preserved food, brewed beer, and in most cases processed their own yarn to make into cloth. In the few small cities and among the larger plantations of the Carolinas and Virginia, some necessities and virtually all luxuries were imported—in return for tobacco and rice and indigo exports, which produced large profits in the London, Bristol and Liverpool markets. Trade and credit were, for them, essential to economic life.

Supportive industry developed as the colonies grew. There appeared a variety of specialized operations like sawmills and grist mills. Shipyards were opened to build fishing fleets and, in time, to build the basic English merchant marine; oak was easily available in New England, although it had become relatively rare in England. Iron

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manufacturing began to develop gradually, starting in the colonial era.

By the 18th century, regional patterns had become clear and reasonably stable. The New England colonies had produced large-scale ship builders and ship operators; plantations in Maryland, Virginia and the Carolinas grew staple crops of tobacco, rice and indigo; the middle colonies (New York, Pennsylvania, New Jersey and Delaware) were shippers of general crops and furs. In all three regions standards of living were very high—higher for working men than in England itself. But because the colonies were slow to show profits, English capital investors withdrew and left the field open to entrepreneurs among the colonists. As a result, by 1770 the North American colonies were economically and politically ready to become part of the emerging self-government movement that had dominated English politics since the time of James I (1603-25). Instead events were to lead to a total political separation. Like the English political turmoil of the 17th and 18th centuries, the American revolution was bourgeois, though rallying points were "unalienable rights to life, liberty and property."

The New Government Considers Its Economy

The Federal Constitution, adopted in 1787 and still in effect, was a work of creative genius in many ways. As an economic charter, it established that the entire nation—stretching from Maine to Georgia, from the Atlantic to the Mississippi Valley—was a common market. There were to be no tariffs or taxes on interstate commerce. The Constitution provided that the federal government alone could (1) regulate commerce with other nations, and among the states, (2) establish uniform bankruptcy laws, (3) print money and regulate its value, (4) fix standards of weights and measures, (5) establish post offices and post roads, and (6) fix the rules governing patents and copyrights.

Alexander Hamilton, a "founding father" and George Washington's first Secretary of the Treasury, advocated this means of economic development: the federal government should nurture infant industries through overt

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Above, prospects of trade drew settlers to the New World colony of Jamestown, Virginia as early as 1607. Below, in 1787 Alexander Hamilton (right), who would become the first U.S. Treasury Secretary, explains his plans for financing the government to future President George Washington (left) and Robert Morris, the Continental Congress's first superintendent of finances.

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subsidies and protective tariffs. He also urged the federal government to create a national bank and assume the colonies' public debts incurred during the Revolutionary War. The new government dallied over some of Hamilton's proposals, but ultimately did make tariffs an essential part of American foreign policy, a position that lasted until the mid-1930s. Although farmers feared that a national bank would serve the rich at the expense of the poor, the first National Bank of the United States was chartered in 1791; it lasted until 1811. Hamilton sought economic growth through diversified shipping, manufacturing, and banking. Hamilton's political rival, Thomas Jefferson, based his political philosophy on protecting the common man from political and economic tyranny. In 1801 Jefferson became President and turned to promoting agrarian democracy.

The Movement South and Westward

After Eli Whitney's invention of the cotton gin in 1793, the cotton market boomed. Planters in the South bought land from small farmers who moved farther west. Soon great land masses, supported by a slave economy, made some families very wealthy.

To many Americans the westward march illustrates a legacy of individualism, a tradition of rising living standards, and an ultimate triumph of business organization. The migration was characterized by three waves of settlers. First came the earliest individualistic pioneers who depended on hunting and fishing for their livelihoods. Their agricultural skills were limited, and all the farm animals they owned were no more than a horse, a cow, some swine, and perhaps some chickens. As a consequence their living standards were minimal. The next class of migrants purchased land, cleared fields from forests, added roads, and permanently settled to stay. Their farms were largely, but not entirely, self-sufficient. The final wave consisted of people with equal or greater enterprise and with abundant stocks of capital. They created and also took advantage of rising property values and thought in terms of profitable business. Their farms were intended to be almost entirely part of the American market economy. And with their farms they built semi-rural communities, offering to everyone standards of living never before imagined.

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An Uncertain Economy: 1820-1860

By the 1820s, America's population was moving ever westward in search of opportunities and advancement. While some historians have referred to these people as being fiercely independent and strongly opposed to government control or interference, many of the settlers apparently believed, as Hamilton had, that the government had a role to play in the expansion of the economy. Perhaps a common thread between these two ideas was the philosophy referred to as the "entrepreneurial spirit." Americans shared a common desire to better themselves through economic participation. Many of the political and economic struggles of the 19th century were fought by people who held differing opinions of how to achieve the same ends. The results of those struggles underline the importance of both individualism and government involvement.

When Andrew Jackson became President in 1829 he was not a poor man, but he was idealized as an individualist by many who were poor (or newly rich) because he had started life in a log cabin in the frontier territory that is now Tennessee. President Jackson opposed the new Federal Bank of the United States, chartered in 1816, because he believed it favored the entrenched interests of the East against the West. When he was reelected for a second term, he opposed renewing the bank's charter, which was due to expire in 1836. Congress supported him in 1833, which effectively killed the second National Bank. Jackson preferred putting the United States government's deposits in the state banks controlled by his political allies. His action helped precipitate the sharp business panics that occurred in 1834 and 1837. The East, particularly the industrial sector, suffered from a cripplingly tight money supply, while in the West the federal deposits in state banks made money more plentiful in rural areas and contributed to land price inflation and land speculation. Illustrative of land speculation is the fact that only 1.6 million hectares changed hands in 1834; but six million hectares were purchased in 1835 and eight million hectares in 1836. The same plot of land often was sold several times; each time at a profit. Treasury income from the sale of land rose from $5 million annually to $20 million. But inherent

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within this boom were the seeds of economic disaster.

The first signs came in 1835 when crop failures made it necessary to import wheat from Europe. Some importers were frightened by the economic depression and refused to extend credit to customers. In 1836, when the money supply in circulation was already low, the Treasury issued an order stating that henceforth land purchased from the government had to be paid for in gold and silver. But these precious metals were in short supply, having been sent abroad to pay for imports. Confidence in the nation's financial system was shaken, even shattered, and western banks began to close. Meanwhile, English traders could not collect on their sales in America, and many of them became bankrupt. Cotton mills closed in England and American planters saw their markets disappear. By the summer of 1837 business was paralyzed, and it was not until the early 1840s that a semblance of confidence in business was restored. Economic dislocations such as "The Panic of 1837" occurred periodically during the 19th century but did not curtail rapid economic growth in the United States. Presidents elected after Jackson also came from the West, or were allied to those who reflected rural sentiments, and they shared Jackson's mistrust of centralized power.

Economic Expansion and Enlarged Markets

The United States was greatly affected by the Industrial Revolution taking place in Europe during the 18th and 19th centuries. New inventions led to the creation of new industries and the spread of economic growth. Europe's growing industrialization influenced similar developments in the United States. For example, the growth of the American economy was made possible largely by developments in the field of transportation.

Beginning in 1825 with the construction of the Erie Canal, which connected New York City with the Great Lakes region, various state governments began to play an active role in stimulating the construction of an internal system of transportation. State government subsidies and loans to businesses undertaking the building of canals and

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turnpikes became commonplace between 1830 and 1860. These early efforts were often marked by corruption and economic disaster, yet more were successes than failures.

River traffic also improved when the steam engine was fitted to boats. The steamboat could sail upriver, against the flow, markedly reducing the amount of time of shipping goods to market.

Like canals and turnpikes, railroads received large amounts of government assistance in the early years. However, unlike other forms of transportation, railroads also attracted a good deal of private investment, both domestic and European.

Railroad building may have seemed an unlikely project to attract private funds. Why? Because the amounts of capital required were enormous; the time before profits could be realized was long, and profits were hard to predict. Yet conservative people in rural areas were tremendously enthusiastic about buying shares of railroad stock, often mortgaging their farms or businesses. Attracted by the vision of local profits and of a better nation, they not only bought stock but also voted for state and local taxes to support the railroads. Later, as part of the Civil War legacy, the federal government gave extensive tracts of land to those who promised to build the missing links in the national railroad system. An astonishing total of 53 million hectares of land were eventually granted to railroad builders. Northern Pacific received 17 million hectares, Southern Pacific got 10 million hectares, and Union Pacific was granted 8 million hectares. But America got its "sea to shining sea" connection.

Europe caught the excitement of investing in American railroads. At one time foreign investors owned the majority of stock in six major railroads. The discovery of gold in 1849 enabled the country to finance imports of railroad machinery and materials.

Abuses also came with the fever and excitement of railroad building. Often, unsuspecting buyers paid exorbitant prices for their railroad stock, or were cheated with stock that was artificially inflated. Get-rich-quick schemes abounded, and many people lost their savings. Fortunes were made overnight by financial manipulators.

Nevertheless, through a combination of vision, for-

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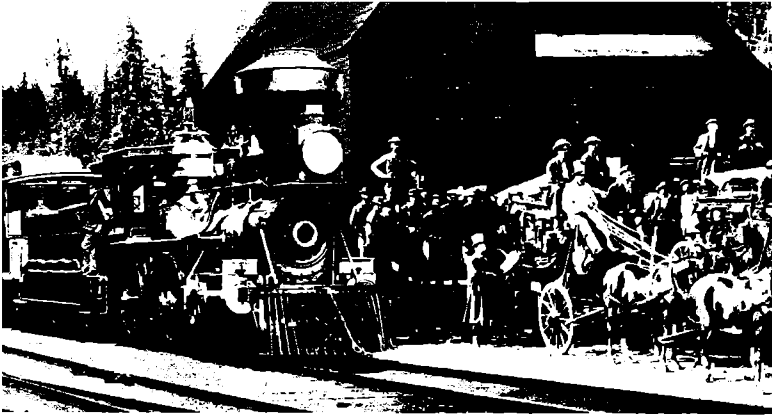

In 1867 the emerging railroad system was competing in the West with stage coach lines as a popular mode of travel. Completion of a nationwide system helped launch the United States into the industrial age.

eign investment, the discovery of gold, and a major commitment of America's wealth, the nation was able to develop a large-scale railroad system, providing the base for the modern industrialization that followed.

Industrial Growth

By 1860, when Abraham Lincoln was elected President, 16 percent of the population lived in urban areas and a third of the nation's income came from manufacturing. Funds were flowing into large-scale industrial development and into railroads. Production of cotton cloth was the leading industry. Other growing activities were the manufacture of shoes, woolen clothing, and machinery. Urbanized industry was limited primarily to the Northeast. Equally important, the nation's population was increasing. Between 1845 and 1855, European immigrants arrived at a rate of 300,000 annually. Most were poor and remained in eastern cities, often at ports of arrival.

In contrast, the old South remained rural and dependent on the North for capital and manufactured goods. Southern economic interests, including slavery, could be

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protected by political power only so long as the South controlled the federal government. The newly organized Republican Party expressed the interests of aggressive industrialization that was sweeping the North. On slavery, Republicans and their presidential candidate, Lincoln, were speaking hesitantly in 1860, but on economic policy they were very clear. In 1861 a protective tariff was adopted. In 1862 the first Pacific railroad was chartered. In 1863-1864 a national bank code was drafted. With northern victory in the Civil War and subsequently at the polls, future economic policy was determined by northern industrialists rather than by southern planters.

Inventions and Resource Development

It was not until after the 1850s that mining became significant. When northern Michigan and Lake Superior iron ore mines opened in the 1850s, the United States gained world superiority in iron and steel. In 1859 Edward Drake struck oil in Pennsylvania; soon after, John D. Rockefeller realized the potential wealth and power to be gained by concentrating control of oil distribution. Soon large copper and silver mines were opened, followed by lead mines and the development of cement factories. In 1893 at the World Exposition, a dynamo was displayed. Such mechanisms were soon built into dams to harness vast amounts of electricity. With the advent of the telegraph and telephone, communications tied the nation together and facilitated large-scale diversified businesses. The use of railroads and improved machinery helped the growth and proliferation of such basic industries as steel, coal, oil, and electric power.

Despite continuing immigration, artisans were scarce, and it made sense for industry to develop assembly lines and mass production methods. Frederick W. Taylor pioneered in the field of scientific management, carefully plotting the functions of various workers and then devising new, more efficient ways for them to do their jobs. True mass production was the inspiration of Henry Ford, who in 1913 adopted the moving assembly line, with each worker doing one simple task in the production of automobiles.

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The Rise of the Tycoon

America once idealized the businessman who amassed a vast financial empire—the business tycoon. His epoch was the second half of the 19th century. It began with the spread of the railroad networks in the 1850s, and included the growth of northern industry in the 1860s, and the rise of investment banking in the 1870s. Throughout this period, business interests had significant influence over government.

The great tycoons were fierce competitors, single-minded in their pursuit of financial success and power. Some of the giants were Jay Gould, J.P. Morgan, Andrew Carnegie, John D. Rockefeller and Henry Ford. Some of these men were honest according to business standards of their day; others used force, bribery and guile to achieve their wealth and power.

The business spirit was not indigenous to America; it grew from the soil of European capitalism. By the time of the American Revolution, businessmen were operating in Italy, Holland, and England. Very early in American history there were industrialists, mostly in New England and along the northeastern seaboard. They were shipbuilders, manufacturers, land speculators, and bankers. Only a few, however, amassed large fortunes.

J. Pierpont Morgan, perhaps the most flamboyant of the entrepreneurs, operated on a scale of magnificence. He displayed aggressiveness and grandeur in his private and business life. He and his companions gambled, sailed yachts, gave lavish parties, built palatial homes, and bought the art treasures of Europe.

In contrast, such men as John D. Rockefeller and Henry Ford demonstrated taut Puritan qualities. They retained their small-town values and life styles. As churchgoers, they felt a sense of responsibility to others. They demonstrated that personal virtues could bring success; theirs was the gospel of work and thrift. Later their heirs would establish the largest philanthropic foundations in America.

While many European intellectuals saw business and moneymaking as degrading, Americans generally embraced it with enthusiasm. They enjoyed the risk and ex-

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citement of business enterprise, as well as the potential rewards of power and acclaim.

By the time of the Great Depression in the 1930s, however, the image of the entrepreneur as an American ideal had lost much of its luster. The crucial change came with the rise of corporation. Few business barons remained. They were replaced by "technocrats" as the heads of corporations. These executives, expert in every phase of corporate activity, became the indispensable cogs in the industrial machine. The high-salaried manager replaced the swaggering tycoon.

The big business leaders today are often involved in many areas of public life. They not only direct the fate of corporations, they also serve on boards in their community and as university trustees. The new corporate leaders fly to Washington to confer with government officials on national policy. They are concerned about the state of the national economy and America's relationship with other nations.

Government Involvement in the Economy

Traditionally, leaders of the U.S. government have been reluctant to become involved in the private sector, except for transportation. In general, the federal government has been influenced by the concept of laissez-faire, or free market enterprise. This attitude began to change during the latter part of the 19th century, when farm and labor movements began to ask the government to intercede on their behalf. By the turn of the century, a new middle class had arisen which not only feared the business elite but the political movements of the farmer and laborer as well. Known as "progressives," these leaders of the middle class favored a government that actively involved itself in the regulation of business practices and the enforcement of competition.

A law regulating the railroads was enacted in 1887 (Interstate Commerce Act) and another law preventing large industries from controlling a single industry was passed in 1890 (Sherman Antitrust Act). However, these laws were not rigorously enforced until those sympathetic to the views of the progressives came to power during the first two decades of the 20th century. During this period,

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many of the regulatory agencies came into being, among them the Interstate Commerce Commission, the Food and Drug Administration, and the Federal Trade Commission.

After a period of prosperity (1920-1929), government involvement in the economy increased during the Great Depression (1929-1937). It was the most serious economic dislocation in the nation's history. At one time nearly one-third of the nation's labor force was unemployed. Government undertook massive public works programs and the complete overhaul and regulation of banking to help the economy recover.

America had to confront successfully problems such as these, as well as develop large-scale industry, banks, stock markets, insurance companies, and credit unions. Along with these manufacturing and financial resources came a modern system of agriculture and a strong labor force. These were the tools that forged America's economic development.

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HOW THE UNITED STATES ECONOMY WORKS: AN OVERVIEW

Irrespective of what many may choose to believe, the marriage between the United States economy and the free enterprise system has not been without problems. From the time of Alexander Hamilton there has been regular resort to governmental intervention into economic matters either to redistribute wealth or to concentrate power. Usually both efforts went on simultaneously. In any event, it does not hurt to start by noting that the great American contribution to social philosophy is "pragmatism." The pragmatic test was that in addition to everything else an acceptable theory had actually to work. Pragmatism is not the same as opportunism; what they have in common is an emphasis on successful accommodation; where they differ is that pragmatism has a philosophical, ethical basis.

This chapter sets up a reasonably simple model of how the American economic system works. It differs from the usual very elementary textbook in that it stresses that the American system has always perceived the government as having a creative role. It also contains two digressions. One is the survey of the 1978 labor force and the other is a discussion of a recent national obsession, "the continuing problem of poverty."

One more thing. Capitalism is a term invented by Karl Marx. He had concentration of control in mind. Capitalism as seen by most Americans is "free enterprise." The idea of the market system can be simply described. But real life and historical experience are not simple things. Thus, this chapter is a compromise between the clarity of an idea and the generalizations that grow out of the historical record.

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The System's Basic Ingredients

The economic system of any nation is the mechanism which brings together natural resources, the labor supply, technology, and the necessary entrepreneurial and managerial talents. Anticipating and then meeting human needs through production and distribution of goods and services is the end purpose of every economic system. While the type of economic system used by a nation is the result of political decision, it is also in even larger part the result of a historical experience, which over time becomes a national culture.

The first ingredient of the system is the natural resources from which goods are produced. America has been blessed by being a land rich in mineral resources and fertile farm soil, together with a moderate climate.

Second, the amount of available labor helps determine the health of an economy. Generally, the United States has been fortunate in having enough people to provide the labor necessary for a constantly expanding economy. Until 1924 most of these workers were white immigrants (or their immediate descendants) who came to America from Europe.[1] When too many laborers arrived from Europe to be absorbed by the East-coast economy, they could move on to farmland in the interior. It is true that at times the country has experienced periods of acute unemployment as well as labor shortages, but on the whole immigrants came when work was plentiful and the economy grew fast enough to absorb them, providing they were willing to work productively at slightly less than the wage rates paid the acculturated workers. They were willing, and they prospered, earning far more than they would have in their native lands. As a result, the economy of the nation also prospered.

[1]It should be noted that vast contributions were made to American economic development by the blacks, virtually all of whose families were descendants of African tribal prisoners sold into slavery and conveyed under abysmal conditions to the New World. Significant contributions were also made by Asians (Chinese, Japanese, Filipinos) who came in large numbers in the early years of this century. But the largest group was the white Europeans.

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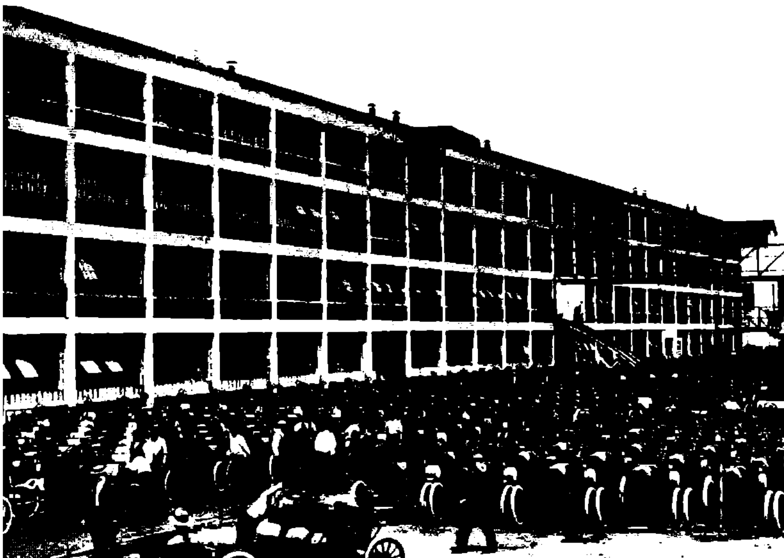
A third factor is the quality of available labor. In assessing the success of an economy one must ask how hard the people are willing to work and how skilled they are. The frontier demanded hard work, and the Protestant religious ethic supported that demand. Further, the strong emphasis placed on education, including technical and vocational education, also contributed to America's economic success. Likewise, the willingness to experiment, to change, and to invest in technology was significant in a land that had prided itself on being a new experiment in freedom.

However, the existence of abundant natural resources and a skillful and willing labor force accounts for only part of the story. These resources must be directed as efficiently as possible into the areas where they will be most productive. In the American economy, capital and management perform this function.

Large blocks of resources must be available for major investments. In America access to these large blocks meant that entrepreneurs had to have money. Money was accumulated and then invested in projects (i.e., used to buy resources, hire workers, and market the product) that

By 1913, America's fast-growing automobile industry was providing jobs for many people. Henry Ford's new mass production techniques, such as the assembly line, signaled a revolutionary advance in American manufacturing.



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seemed to the investor to be likely to give a high return on the original investment. Naturally, investors decide to spend their capital according to the desires and needs of those who buy goods and services.

Once the original entrepreneurial investment of capital has been made, someone must be hired to manage the new business, factory, or other endeavor. Modern America has developed a chain of command, from the foreman on the loading dock to the executive in the conference room, whose job is to see that things run smoothly and efficiently. Good management can often make the difference between a successful or unsuccessful operation. In America management was said to be mostly a matter of systematic analysis; "scientific management" became a veritable movement.

A Mixed Economy: The United States System

The economic system of the United States, which brings together the resources that we have been describing, is principally privately owned. This system is often referred to as the "free enterprise system" and can be contrasted to a socialist economy, which depends heavily on government planning and on public ownership of the means of production. It should be noted that although the United States operates a system of private enterprise, government has to some extent always been involved in regulating and guiding the American economy. Yet despite this history of government intervention, individuals in the United States have always been able to choose for whom they will work and what they will buy. Most important, they vote for officials who will set economic policy.

Traditionally, the system has been referred to as a "market economy." Now decisions are made by three groups and it is their dynamic interaction that makes the economy function. Consumers, producers, and government make economic decisions on a daily basis, the primary force being between producers and consumers; hence the market economy designation.

Consumers look for the best values for what they spend while producers seek the best price and profit for what they have to sell. Government, at the federal, state,

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and local levels, seeks to promote the public safety, assure fair competition, and provide a range of services believed to be better performed by public rather than private enterprise. Some of these public services include education, the postal (but not the telephone) service, the road system, social statistical reporting and, of course, national defense.

In this system, when economic forces are unfettered, supply and demand create the price of goods and services. Entrepreneurs are free to develop their businesses. In theory, unless they can provide goods or services of a quality and price to compete with others, they are driven from the market, so only the most efficient and those who best serve the public remain in business.

In the United States most people are simultaneously consumers and producers; they are also voters who help influence the decisions of government. The mixture among consumers, producers, and government changes constantly, making a dynamic rather than a static economy. In the last decade consumers have made their concerns known and government has responded by creating agencies to protect consumer interests and promote the general public welfare. In another development, the population and the labor force have moved dramatically from farms to cities, from the fields to the factories, and above all to service industries, thus providing more personal and public services. In today's economy these providers of services far outnumber producers of agricultural and manufactured goods.

From 1960 through September 1980 the labor force grew from 70 to 105 million, including 7.5 million who reported that they could not find jobs. Of the remaining 97.2 million, some 7 million non-farmers were self-employed and another 3.4 million were in agriculture. The remaining 86.8 million Americans were working for others at an hourly wage or salary in industry, business, voluntary associations, or government. These statistics reveal a rather startling shift away from self-employment to working for others.

Generally, there are three kinds of businesses: (1) those started and managed personally by single owners or single entrepreneurs; (2) the partnership where two or more people share the risks and rewards of a business, and (3) the corporation where stockholders as owners can buy

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or sell their shares at any time on the open market. This latter structure, by far the most important, permits the amassing of large sums of money by combining investments of many people, making possible large-scale enterprise.

Government's Role in the Economy

Consumers and producers obviously make decisions that mold the economy, but there is a third major element to consider: the role of government. Government has a powerful effect on the economy in at least four ways:

Direct Services. The postal system, for example, is a federal system serving the entire nation, as is the large and complex military establishment. Conversely, the construction and maintenance of most highways is the responsibility of the individual states, and the public educational systems, despite a large funding role by the federal government, are primarily paid for by county or city governments. Police and fire protection and sanitation services are also the responsibilities of local government.

Regulation and Control. The government regulates and controls private enterprise in many ways, for the purpose of assuring that business serves the best interests of the people as a whole. Regulation is necessary in areas where private enterprise is granted a monopoly, such as in telephone or electric service, or in other areas where there is limited competition, as with railroads or airlines. Public policy permits such companies to make a reasonable profit, but limits their ability to raise prices "unfairly" (as defined by the regulators), since the public depends on their services. Often control is exercised to protect the public, as for example, when the Food and Drug Administration bans harmful drugs, or requires standards of quality in food. In other industries, government sets guidelines to ensure fair competition without using direct control.

Stabilization and Growth. Branches of government, including Congress and such entities as the Federal Reserve Board, attempt to control the extremes of boom and bust, of inflation and depression, by adjusting tax rates (including regulations pertaining to depreciation), the money supply, and the use of credit. They can also affect the economy through changes in the amount of public spending by the government itself.

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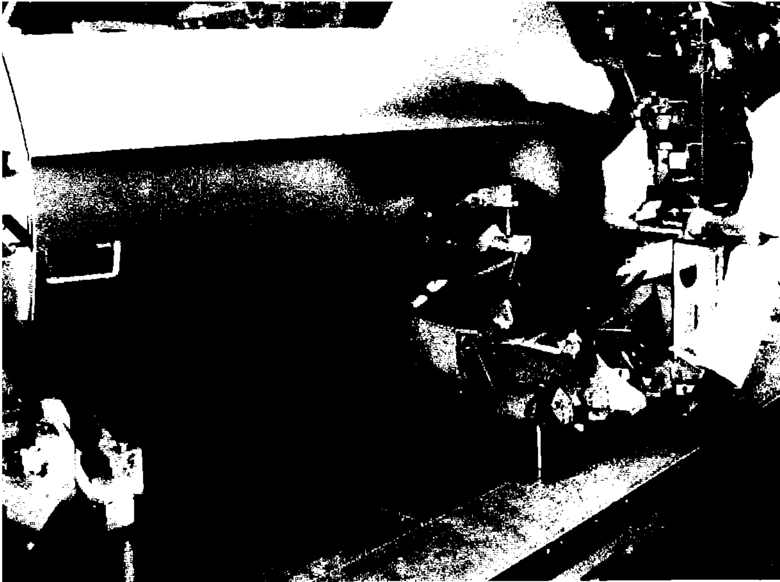

Quality control is a critical component of mass production. Here, an inspector uses a gauge to insure that an auto body side meets engineering measurements specifications.

Direct Assistance. The government provides many kinds of help to businesses and individuals. For example, tariffs permit certain products to remain relatively free of foreign competition; imports are sometimes taxed so that American products are able to compete better with certain foreign goods. Government also provides aid to farmers by subsidizing prices they receive for their crops. In quite a different area, government supports individuals who cannot adequately care for themselves, by making grants to working parents with dependent children, by providing medical care for the aged and the indigent, and through social insurance programs to help the unemployed and retirees. Government also supplies relief for the poor and help for the disabled.

The Growth of Government

As the population has increased, and as the basic standard of living of the American people has risen, the public has come to expect more government services than in any previous era. It might be added that more services

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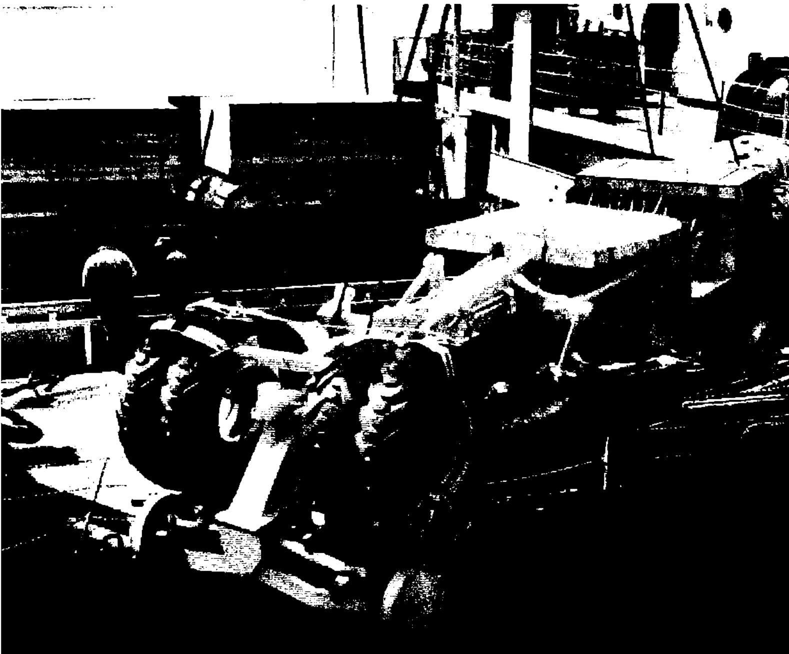
become economically feasible when large numbers of people are crowded into cities. For example, collection costs for garbage would be prohibitive in rural areas because of the dispersed population, but it is practical—and necessary—in big cities.

The rate of growth of government has been greater at state and local levels than at the federal level. More units of government develop as new towns and suburbs spring up in what were previously fields. In 1977 there were almost 80,000 local governments in the nation, greatly increasing the number of their public employees. From 1959 to 1979, the number of federal employees rose slowly from 2.4 to 2.8 million persons, while state and local units of government increased their employees from 6.1 million to 12.9 million during the same period.

Before going further, it may be useful to get some perspective on the national debt. Over the 20 fiscal years between 1959 and 1978, the federal government had deficits 18 times. The total debt of all units of government at

High-technology U.S. products, such as the road grader being loaded on a freighter for export, are competitive with similar goods manufactured abroad, unlike many low-technology U.S. goods.



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the end of 1976 was estimated at almost $833,000 million, with $597,000 million of this at the federal level. By comparison, the mortgage debt in 1976 on all private homes was around $684,000 million, while the 1976 debt on factories, equipment, and materials for corporate industry was over $1,415,000 million, twice as much as for all government units combined. The real significance of the debt is seen by comparing it with the wealth of the nation, or the gross national product (see below), which has been increasing as rapidly as the debt.

Output of Goods and Services

Almost two-thirds of the nation's total economic output consists of goods and services bought by individuals for personal use. The remaining one-third is bought by government and business. Because of this ratio, the nation has been characterized also as a "consumer economy."

It is evident then, that the consumer will exert a measure of influence over the market economy. Naturally, most consumers look for good values when they buy, as well as for product reliability and safety. If one automaker produces a better car at a lower price, the market will begin to shift, so that that car attracts more sales than its competitors. In theory, this phenomenon rewards efficient producers who maintain high quality at a low price, and drives out those who cannot compete.

Providers of goods and services include owners, managers, and workers. Owners and managers make decisions on what and how to produce, relying on what they think the public will buy and expecting to earn a profit from their business operations.

The Gross National Product (GNP) measures the total output of goods and services in a given year. A word of caution is in order when using GNP as an indicator of national well-being. Environmentalists and philosophers point out that GNP is not an adequate measure of the quality of life in a nation—it only measures the market value of the goods and services. Economic growth, in contrast, creates the increasingly difficult problem of maintaining a clean and healthy environment.

In 1979 the U.S. economy produced $2,368,800 mil-

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lion in GNP. Its size was greater than the GNP of the U.S.S.R., West Germany, and France combined.

The Continuing Problem of Poverty

Americans have been troubled, over the years, by an inability to eradicate completely the existence of poverty in the United States. Through the Department of Labor, government has defined a minimum amount of income necessary for basic maintenance of a family of four. The amount may fluctuate, depending upon inflation and the cost of living and where the family lives. While poverty still exists for all too many people, the amount of families below the poverty line went down steadily from 1960 to 1974, when a small increase was observed again.

> "In 1973, there were 23 million people officially regarded as poor. However, those 23 million people received $18,800 million of such in-kind transfers as food stamps, health care, and public housing. The lowest fifth income group in 1960 was estimated to have 4.8 percent of the nation's money income. In terms of total income, it had 5 percent. In 1973, it was estimated...that this lowest fifth obtained only 5.5 percent of total money income. However, when in-kind transfers are added to the money income figure for 1973, the estimated share of the first quintile [fifth] reaches about 12 percent. Indeed, when these non-cash forms of income are included, the relative position of the poorest fifth of families is improved by over 100 percent between 1960 and 1973."[1]

Summary and Conclusion

Thanks to abundant natural resources, an adequate labor force, and a people who recognize the importance of education, training, and creativity in production and management, the United States has been a successful experi-

[1]Roger LeRoy Miller, *Economics Today*, Third Edition (New York and London: Harper and Row, 1979), p. 561.

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ment. Considerable freedom exists within the economic system for individuals and groups to take risks, experiment, and make profits. Increasingly, government is intervening to regulate and guide the economy in its continued growth. And for all its vitality, America faces problems of poverty, unemployment, and environmental pollution. Some of these social ills are caused, in part, by the very success of the economy. One of the tasks of the next several decades will be to make headway against these difficult problems.

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SMALL BUSINESS IN THE AMERICAN FREE ENTERPRISE SYSTEM

Earlier we noted that a dominant theme in American history is economic opportunity for the individual. In the 17th and 18th centuries this theme took the form of admiration of the pioneer. Combining all the moral qualities of the sturdy yeoman, the pioneer also enjoyed the geographic distance between himself and his neighbors. It is reported that Daniel Boone, legendary as an early American pioneer, claimed that when he could see the smoke from his neighbor's chimney, it was time for him to move farther west.

In the 19th and 20th centuries the prototype individualist in America was the homesteading farmer (if he lived in the country) or a small merchant, independent craftsman, or self-reliant professional man (if he lived in the city).

A very significant proportion of contemporary Americans are descendants of small merchants, craftsmen, and professional people. Their heritage stresses the advantages of business independence. But just what does business independence mean?

This chapter will attempt to explain the organization of independent business in the American economy and society. Although lacking in historical dimension, its very importance is based on the significance that 19th- and early 20th-century Americans, particularly Central and East European immigrants, attached to "having a store," "being a plumber," or, better yet, "having a medical practice." Tales of peddlers becoming small merchants are legion; virtually every urban family has not one but several of these stories as part of the family history.

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Perhaps the American frontier fostered the notion of "everybody is an entrepreneur." It was possible on the frontier for families to homestead their land, to take it simply by "squatters' rights," or to purchase it on credit and make payment over many years. The vast expanse of the land permitted Americans to become a nation of agricultural entrepreneurs. The dream of business success grew as America shifted from rural to urban and from farming to other types of business.

Many visitors from abroad, accustomed to thinking of the United States as a land of big business, are amazed to find the large number of small businesses. Without them the nation would be very different. These small businesses, including small corporations, provide a more personal dimension to the relationship between producer or salesman and customer than is present in the large corporation. The federal Small Business Administration reported in 1976 that 97 percent of all businesses were small, a total of 10 million, plus another three million farmers. In this chapter we shall examine single-owner businesses and partnerships. We shall leave for the next chapter a consideration of corporations, particularly the largest and the most powerful corporations.

The Single Proprietor

Many businesses are owned and operated by a single person. Such firms are called "individual proprietorships." When an individual decides to open such a business, let us say, a restaurant, that person is then entirely responsible for its success or failure. Any profits go to the owner, who must assume any losses that are incurred. If the losses prove to be greater than the investment, the individual is responsible for paying them, even if this depletes all personal assets.

Among the advantages of individual proprietorship is that an owner can make decisions quickly and decisively without having to consult others. And an individual proprietor, by law, pays fewer taxes and at a lower rate than does a corporation.

There are obvious limitations to this form of business organization, however. An individual proprietorship ends with the death of the owner. Of course, the assets can be

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inherited by a person who may then become the operator, but legally the business dies with its owner. Also, since it is dependent upon the amount of money the owner has saved or can borrow, usually it does not develop into a large-scale enterprise. Given these limitations, the individual proprietorship is well adapted to many kinds of small businesses and suits the temperament of many persons who like to exercise initiative and be their own bosses.

Some economic values of small business are: (1) A small business is often the starting point for developing a new product or service. One person has an idea which he tries. If it is successful, his business grows, or it may be bought by a larger one. (2) The small business can give an individual the chance to gain experience, which he may utilize later on a larger scale. (3) Small businesses may have advantages over large ones in meeting local needs. Often the need is specialized so that big business is inappropriate. For example, a community may require a shoe repair shop, which would support an individual cobbler, serving one neighborhood. (4) Many customers grow weary of mass-produced goods and welcome the individualized products made by artisans. (5) Some businesses provide a service where knowing one's customers is important. (6) The customer often prefers to deal with an individual proprietor because he can count on that person's concern to do a good job and provide friendly service. (7) Many small businesses grow into large ones, thus adding to the economic vitality of the nation. While thousands of small ventures fail, many succeed. They are part of the ferment, the creativity, and the competition that provide new strength to keep the economy from stagnation.

The Business Partnership

When a proprietor wants to expand a business, one way to do so is to form a partnership, a business enterprise formed for profit by two or more co-owners. The rights and duties in a partnership are regulated by laws of the state where it is formed and by a legal agreement entered into by the co-owners. Usually, an agreement specifies the amount of money each is investing, and the duties each partner assumes. A partnership agreement also may provide for a "silent partner" who does not take part in the

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Competition from supermarkets has not eliminated the general merchandising store, such as this one in rural Virginia.

management, but who invests money in the business.

The partnership has the advantage of pooling managerial talent. One partner may be qualified in production, another in selling. The partnership, like individual ownership, is exempt from most reports the government requires of corporations. Furthermore, it has a favorable tax position when compared with the corporation. Federal income taxes are paid by individual partners on their share of earnings; beyond that the business is not taxed.

A major disadvantage of the partnership is that each member is liable for all the debts of the partnership; the act of any partner is legally binding upon all the others. If one partner takes a large amount of money from the business and squanders it, the others must pay the debt. Partnerships suffer another major disadvantage: if the partners dis-

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agree over the philosophy or planning for the business, resulting in serious and constant disagreement, the business is bound to suffer.

Nonetheless, the partnership remains a vital part of the total business economy. The Internal Revenue Service, the tax collecting agency of the federal Treasury Department, reports that there are still half as many business partnerships as corporations.

Laws Governing Bankruptcy

Bankruptcy is regulated by federal laws, which provide for an orderly adjustment when a person or business becomes insolvent. When one has more debts than assets and has no means of meeting debt payment, he may declare bankruptcy. The interests of both creditors and debtor are given consideration by the court.

The Constitution gives Congress the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States" (Article I, Section 8). The first bankruptcy act was passed by Congress in 1800, patterned on English law. It was repealed in 1803 and for the next 40 years debtors were subject to state laws. The second federal law, enacted in 1841, was a consequence of the depression and panic of 1837. Several subsequent bankruptcy laws were enacted and repealed.

The act on which current law is based was passed in 1898. Amending acts in 1933, 1934, and 1935 attempted to help honest debtors rehabilitate themselves. The Chandler Act of 1938 was designed to protect creditors from exploitation in the settlement of corporate bankruptcy cases, allowing these creditors free legal assistance from the federal Securities and Exchange Commission.

When a person or corporation decides that debt has become too burdensome, a petition of bankruptcy is filed. At that point the court assumes control over the assets of the debtor. A custodian or trustee is appointed to oversee the debtor's property to protect it from loss. This trustee has legal ownership of all assets of the bankrupt estate except those exempt under local law.

The two main types of bankruptcy are the "voluntary" petition, filed by the debtor himself, and the "involuntary" proceeding, filed against him by his creditors.

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Once a bankruptcy proceeding has been started, the property of the debtor must be sold and the proceeds distributed in an orderly manner. Every creditor must be able to prove that money is actually owed to him. The money that is available after everything is sold is then divided on a percentage basis, so that each creditor receives a fair proportion of the total money available.

From the debtor's point of view, the primary object of bankruptcy is to give him a fresh start. He is legally discharged from all previous obligations, assuming that his former debts were legal. In like manner the corporation goes out of existence, or is reorganized and starts again in another form.

SBA: Factors For and Against

Analysts of small business recognize that several economic factors tend to thwart this business form. To offset these factors, positive legislation has been enacted.

The Small Business Administration (SBA) was created within the Department of Commerce to help small business enterprise. In Washington, D.C., and in regional offices around the country, trained specialists provide advice and assistance to those wishing to form small businesses, or to those already operating such businesses who need assistance.

Since 1970 the SBA has approved more than $20,000 million in business loans. In 1977 alone the SBA made loans of more than $3,000 million to 31,800 businesses.

The agency's major financial assistance is provided through its Guaranty Bank Loan program, which accounts for 90 percent of all loans. The SBA works with 8,500 banks that make the loans to businesses, with the federal government guaranteeing payment should the entrepreneur default.

Responding to concerns of Congress and Presidents about revitalizating decaying urban areas, the SBA has a program to provide special concessions to small businesses in communities that are rebuilding.

A unique feature of the SBA is the management assistance that is offered to new or faltering businesses. Successful entrepreneurs who are retired volunteer their services to help others in a program called Service Corps of

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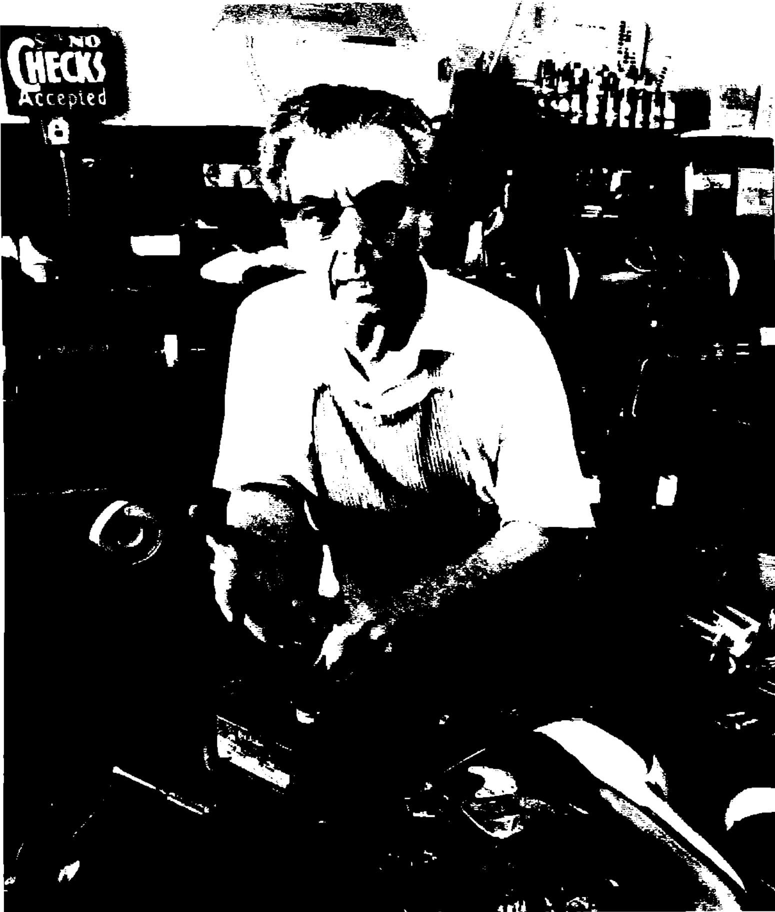

Many immigrants who come to the U.S. start small family businesses. Nick Nicholas, son of a Lebanese immigrant, operates a shoe repair shop in Texas.

Retired Executives (SCORE). Another program, begun in 1976, is operated by the University Business Development Center (UBDC) and is designed to open the resources of universities to new and existing businesses.

The SBA makes a serious effort to fund programs for minorities, especially blacks and Spanish-Americans. The agency also administers an aggressive program to identify international markets and joint venture opportunities for small businesses that have export potential.

Disaster relief is another program pursued by the SBA

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since its inception. It offers assistance to homeowners, business firms, and others suffering physical damage as a result of floods, hurricanes, tornadoes, and other natural disasters.

In June 1976 the President signed Public Law 94-305 which made changes in the financing of SBA programs. The new law authorizes business loans for periods up to 20 years to acquire real property or to construct facilities; raises the ceiling to any one borrower up to $500,000 under the guaranty program; and makes small farms and agriculturally related industries eligible for all SBA programs.

The SBA has a significant impact in assisting smaller proprietorships and corporations by making available necessary financing and professional expertise. This service is provided at relatively small cost, as most of the loans are repaid directly to the lending banks from which the money was borrowed.

Once a dominant economic force, farmers now constitute a small percentage of American workers. This family loading alfalfa hay contour strips owns the farm.

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Franchising is another practice favorable to small business; it has increased greatly in recent years. A common practice in the restaurant business, franchising combines the economic efficiencies of the large corporation with the benefits of local ownership. In this transaction, a large company allows an individual or small group of entrepreneurs to use its name (often a distinct advertising advantage) and sometimes its products in exchange for a percentage of the profits. The entrepreneur, who is usually not an employee of the parent company, is responsible for the management and operation of one or several units of the larger chain. The individual owner or owners must also assume most of the risks connected with the enterprise.

The rise of chain stores is a significant factor militating against small business. They have invaded the domain of what was once the single proprietor or the partnership. In food retailing, for example, chain grocery stores have become dominant, driving out many small businesses. These chain stores use mass methods, buy in large quantities, maintain a high volume of sales, and stress self-service. Because they buy cheaply and generate large sales volume, they are usually able to sell at lower prices than family-owned stores. Nonetheless, some independents do survive. Some individual proprietors join forces with others to form chains of independents, or sometimes cooperatives, pooling their buying power.

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THE DEVELOPMENT OF GIANT CORPORATIONS

In any discussion of the American corporation, several themes stand out. Its large size is principally due to the need to amass capital. Capital can best be amassed when the business firm that is seeking it is well known. Moreover, as Supreme Court Justice Oliver Wendell Holmes wrote a century ago, "the end of competition is monopoly." By this he meant that although firms compete, ultimately one becomes dominant and is likely to absorb most, if not all, of the rest.

This chapter will attempt to explain the theory of the corporation. It will also try to explain how corporation ownership has become divorced from control. The officers who run corporations often represent only a small fraction of the total number of shareholders. It is hard for dissatisfied owners to "force them out," unless the managers have been guilty of gross negligence. In recent years, the federal Securities and Exchange Commission has taken responsibility for policing certain political and ethical activities. In these instances, management is vulnerable.

Another tendency has revealed itself recently that has made management of large American corporations less than a pleasant dream. Corporations, even those controlled by directors holding a very small percentage of the shares, are particularly vulnerable to raids by other corporations, which do not have to buy very many shares to be in a position to shape the first corporation's policies. This movement toward conglomeration, which often reflects the aggressiveness of corporate life, has become an omnipresent headache for the leadership of American corporations.

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Many activities of the economy necessitate operation by larger business units. The vast American economy now depends increasingly upon the vigor and effectiveness of its largest corporations. These giants supply goods and services on a national scale; people benefit from the availability of brand names that guarantee a certain level of quality wherever purchased, and also from the fact that brand name items cost less because of large volume and small overhead costs per unit sold. To be able to produce in huge quantities, a corporation must have access to vast amounts of capital. Since the corporate form of management can bring together such amounts of capital, and because it offers attractive legal protections, this type of organization has become effectively dominant in American business.

When many people bring together their financial resources in a corporation, the result is not just a loose association of investors. In the eyes of the law the corporation becomes a person. Indeed, the Latin word *corpus* means "body" or "person." This new non-organic person is created when a charter is issued by a state.

As a legal entity, distinct from any particular person, a corporation can own property, sue or be sued in court, and make contracts. Thus it provides an ideal vehicle for the conduct of business by the larger enterprises.

Advantages of Corporations

The corporate form of business organization has at least four distinct advantages. First, it safeguards its owners, relieving them of legal responsibility as individuals when they act as agents of the business.

Second, the owner of shares of stock has limited liability; that is, he cannot lose more money than he invests. He has no personal responsibility for the debts of that "person," the corporation. If he has 10 shares of stock for which he paid $100 and the corporation goes bankrupt, he is apt to lose the $100 he invested but is not liable for the large unpaid debt.

Third, corporate stock is transferable. An owner of stock can sell his holdings at any time. If the owner dies, the stock is passed along to his heirs. Thus, the corporation is not damaged by the death or disinterest of a particular person. It has a perpetual life of its own apart from the

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people who happen to own shares of stock at a given time.

Finally, the corporation can raise large amounts of capital by selling stock.

Disadvantages of the Corporation

The corporate form of organization has some disadvantages when viewed by the investor or manager. Double taxation poses the first problem. As a separate legal entity, the corporation must pay taxes. Then, when the business passes along profits in the form of dividends, the individual owners are taxed again on these dividends. Another disadvantage is that the managers are subject to more government regulation than are individual proprietors or partnerships. Often they complain of having to submit endless reports to state and federal agencies.

Another disadvantage results from the fact that ownership becomes separated from management. While this makes management easier, some managers may be tempted to act more in their own interests than those of the stockholders.

How Corporations Raise Capital

The large corporation has grown to its present size (and continues to grow) because it has found ways to raise new capital for further expansion. Of course, the corporation, like the individual, can buy goods and services on credit or can mortgage its assets, including buildings and equipment. However, these methods of getting additional money are insignificant in raising funds needed for major expansion. There are five primary methods used by corporations to raise new capital:

(1) *Sale of common stock.* Holders of bonds have lent money to the company, but they have no voice in its affairs, nor do they share in profits or losses. Quite the reverse is true for investors who buy common stock. They own shares in the corporation, but receive no dividends until interest payments are made on outstanding bonds. If the company's financial health is good and its assets sufficient, it can create capital by voting to issue additional shares of common stock. As the shares are sold, the funds received can be used for expansion. For a large company,

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an investment banker agrees to guarantee the purchase of a new stock issue at a set price. If the market refuses to buy the issue at a minimum price, the banker will take them and absorb the loss.

(2) *Issuing preferred stock.* This stock when issued pays a "preferred" dividend. That is, if profits are limited, the owner of preferred stock will be paid dividends before those with common stock. Legally, the owner of this stock stands next in line to the bondholder in getting paid. A company may choose to issue new preferred stock when additional capital is desired.

(3) *Issuing bonds.* A bond is a promissory note, usually issued for a specified amount. It is sold on the bond market with the promise to pay interest every six months or every year. Should the holder of the bond wish to get back his money before the note is due, the bond may be sold to someone else. When the bond reaches "maturity," the company promises to pay back the principal at its face value. The interest paid on the bond is usually called "coupon" payment because the owner cuts off a certain piece of the bond every period and mails it to the company to receive payment. Ordinarily, the company agrees to pay interest on its bonds whether or not a profit is made. For this reason a smaller corporation can seldom raise much capital by issuing bonds.

(4) *Borrowing.* Companies can also raise capital by borrowing from lending institutions, primarily banks and savings-and-loan establishments. The borrower must pay the lender interest on the loan, at a rate determined by competitive market forces. In addition, the rate of interest can be influenced by the amount of funds in the overall money supply available for loans. If money is scarce, interest rates will tend to rise because those seeking loans will be competing for funds; if plenty of money is available for loans, the rate will tend to move downward. If the borrower later finds that it needs to raise additional money, it may do so by refinancing an existing loan. In this transaction the lender is essentially loaning more money to its creditor. Note that if interest rates have gone up during the period since the original loan was secured, borrowers are paying a higher rate for the luxury of holding additional funds. If the rate has gone down, the lender still has the advantage of having increased the size of its original loan.

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(5) *Using profits.* Some corporations pay out most of their profits in the form of dividends to their stockholders. Investors buy into these companies because they want a high income on a regular basis. But other corporations, usually called "growth companies," prefer to take most of their profits and reinvest them in expansion. Persons who own such stocks are content to accept a smaller dividend or none at all, if by rapid growth the shares increase in price. These persons prefer to take the risk of obtaining a "capital gain," or rise in value of the stock, rather than be assured a steady dividend.

The typical corporation likes to keep a balance among these methods of raising money for expansion. Unless some dividends are paid, investors may lose interest in the company. Bonds are desirable for the company because interest paid on debt is deductible for tax purposes and the interest rate is lower than in most other types of borrowing. The disadvantage is that payment must be made on bonds even when no profits are earned. Preferred stock requires a slightly higher dividend and is more flexible in that dividends are not mandatory when the company has financial woes. Common stock is most flexible, but only so many shares can be issued before they begin to lose their value. Like printing paper money, issuing too much stock can diminish the basic value of each unit.

The Trend Toward Bigness

Using these methods to facilitate growth, many corporations have gained tremendous size and power. Some 500 major corporations occupy a dominant place in American business. In terms of sales and numbers of people employed, these corporations are as wealthy as many nations. The 500 largest American corporations together employed 15,785,439 persons in 1978. They had total profits of $61,500 million and assets of $898,500 million.

This tremendous concentration of economic power in the hands of major corporations may be understood better by considering the following statistics: The top 500 own about 40 percent of the assets of all nonfinancial corporations, more than a third of all bank assets, and about 85 percent of all life-insurance assets. They have more than half the sales and make 70 percent of all corporate profits.

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The largest 200 corporations hold between 20 and 25 percent of the income-producing wealth of the nation. More than 300 of the largest 500 have assets in excess of $1,000 million. There are five corporations that handle more money than any one of the 50 states.

General Motors (cars) was in 1978 the largest corporation in the United States, reporting sales of $63,200 million. Exxon (oil) was second with $60,300 million in sales. Ford Motor Company (cars) was in third place, followed by Mobil, Texaco, and Standard (all oil) in fourth, fifth, and sixth places. International Business Machines (computers) was number seven; General Electric (appliances), eight; Gulf (oil), nine; and Chrysler (cars), number 10.

The Arguments for Bigness

Many Americans argue that big corporations should be dismantled into smaller ones, through government orders forcing them to sell parts of their operations. Others say that the problem is monopoly, not bigness. This brings us to the question of how valuable large, well-run corporations are to society when they do not constitute monopolies.

Large corporations have the financial strength necessary to move into research, development, and production of new goods. In addition, the scientific know-how and technical capability of large companies provide the United States with production capacity that is deemed necessary for military preparedness.

Proponents of bigness note that the high standard of living for the majority of people evolved during the time big business was expanding. They argue that big business has been efficient, generally, in both production and distribution of goods and that with mass production, prices have been lowered to the point where goods are available to an ever larger portion of the population.

The Trend Toward Monopoly

Those who disapprove of bigness point to the effects of monopoly on the economy. Many of the nation's basic industries are represented by only a few major corporations. In the automobile industry, for example, there are three giants: General Motors, Ford, and Chrysler. In the field of electrical

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The annual stockholders meeting of The American Telephone and Telegraph Company (AT&T) accommodates only a miniscule fraction of the three million people who hold stock in America's most broadly owned corporation.

supplies, General Electric controls a major share of the business. In computers, International Business Machines has the dominant position.

Often large companies take control of smaller ones in their field by buying their stock on the open market. At other times, managers of a large company agree to buy the stock of a smaller one at a fixed price. At other times two very large companies agree to merge, forming a still larger giant. After competition is eliminated, the giants can then fix prices. People who need their products then have little choice but to pay the prices the companies set.

In the past century, there has been real concern over the breakdown of competition and the control of basic industries by a few large corporations. One task of the United States Justice Department is to study cases where there appears to be danger of monopoly and to prevent mergers or take steps to break up companies when lack of competition can be proved to hurt the consumer.

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The Conglomerate

In recent years many corporations have chosen to become conglomerates; that is, they have expanded into the production and sale of products quite different from those with which they were initially involved. At the same time, they may have bought existing companies in very different fields.

Management's rationale when moving in this direction is that it is unwise to have "all eggs in one basket." If the demand for one product slackens, another line of business can provide balance. Thus, a company identified with the extraction of metals may become a conglomerate by moving into retail food, automobile accessories, and motion pictures.

A number of major corporations pride themselves on the high quality of their management. They seek to purchase struggling smaller companies where the quality of management is inferior. They hope their superior management ability will change the smaller company into a profitable enterprise through leadership and, perhaps, additional capital.

Automation increases productivity—but also unemployment. At an automobile assembly line in Ohio, automatic welding equipment places 95 percent of the 3,900 welds on each car body.

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Separation of Ownership and Control

Perhaps the most striking feature of the large corporation is its great number of shareholders (in effect, owners). Every day thousands of shares of stock in a given corporation are bought and sold. A major company may be owned by a million or more people, many of whom own fewer than a hundred shares. By the mid-1970s about 30 million persons in the United States owned common stock.

When so many people living in all parts of the country own stock, they find it impossible to know all details of their business, so it is difficult for them to decide wisely concerning policies. In a typical giant corporation directors and managers own less than five percent of the common stock. Often major blocks are owned or controlled by individuals, banks, or retirement funds, but these persons and groups usually own only a fraction of the total.

In this situation, effective control is in the hands of the board of directors. Beyond making policy, the board places operational control in the hands of a president or chief executive officer. The board meets monthly or quarterly to consider policy related to operational decisions and to review accomplishments. At annual meetings new directors are added as needed, and major policy decisions are made.

Until recent years only a handful of people would normally attend the annual meeting of a corporation. Now, in many instances, several hundred attend. Often they ask management hard questions. In recent years the Securities and Exchange Commission has ruled that every corporation must send a written notice of the annual meeting to every stockholder. Also, groups that are challenging management are permitted access to mailing lists of stockholders, so that all sides can present their views.

Corporate Leadership

Unless there is a crisis, however, the primary decisions are made by professional managers. In an earlier age, the entrepreneur who developed his own business exercised control. Now most original founders have been replaced by a new type of executive who probably acquired

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professional skills at a university, often studying three or four years at a graduate school of business administration.

Typically, the dominant leader is called the president. This officer usually has a number of vice-presidents who manage various aspects of the corporation and report to him or her. The chairman of the board is often an experienced executive who, together with the executive committee of the board, gives advice and approval to the president and many vice-presidents. Typically, as long as the president has the confidence of the board, he or she is permitted a great deal of freedom in the operation of the company.

The makeup and role of the board of directors varies from one company to another. In some corporations most of the board members are internal officers of the corporation, but usually such officers are a minority. Some directors are selected to give prestige to the board, others have special skills that are needed, while a few may represent banks or other leading institutions. It is not unusual for the same person to serve concurrently on several different corporate boards.

Corporate Philanthropy

United States corporations donate to charity and other nonprofit purposes some $1,600 million annually. Corporations differ in their reasons for giving and in the types of projects they support. The money is used to support private colleges and universities, local hospitals, or social betterment programs. Total donations by a corporation average about one percent of pretax corporate profits. Such philanthropy is encouraged by government, and the money is deductible from taxable income.

Especially since the 1960s corporate executives have been persuaded that they have a role to play in alleviating the poverty of cities. They have also accepted the principle that they have a part in providing more employment opportunities and job-training programs for members of minority groups and persons without basic skills.

Corporations offer various explanations for their philanthropy. First among the motives is essential altruism, a simple recognition of social responsibility beyond production and the making of profit for shareholders. Second, corporations contribute because of the indirect social gains they receive in return. The funds often are seen as engendering good will from

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the public; or the cost may be judged as being less than if government paid for all services to the community and then raised corporate taxes accordingly. Other corporations are interested in supporting projects that will be looked on with favor by Congress, which regulates their fortunes. Third, corporations give for reasons that directly benefit them. For example, a technical instrument company may donate to university engineering programs that provide high quality graduates who come to work for the company.

Government, in turn, provides tax write-offs for corporate philanthropy out of the belief that many centers of support for socially needed programs help contribute to a dynamic solution to the human problems of society. Many centers of interest and expertise are preferred over a single system supported by the government alone.

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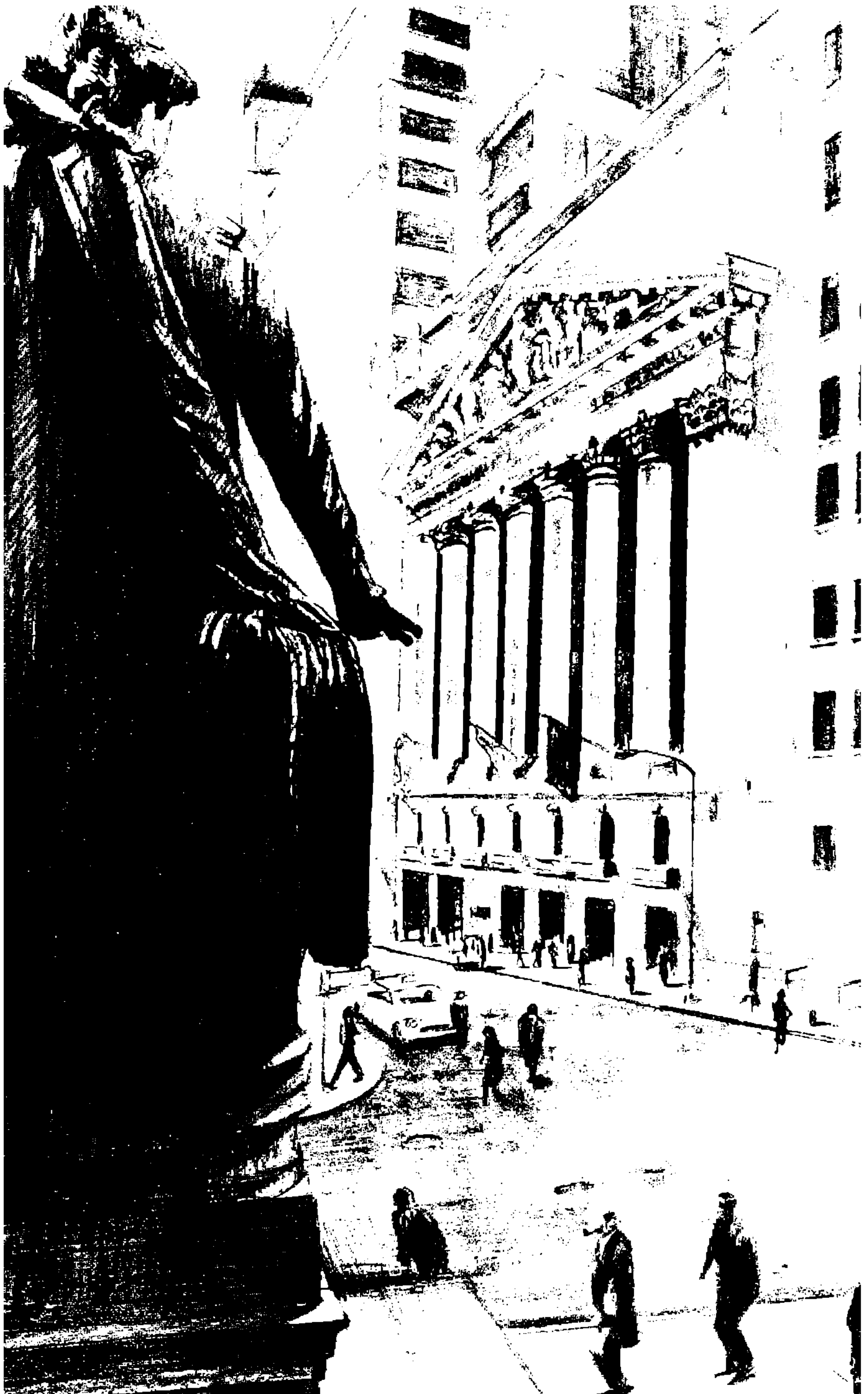

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STOCKS, COMMODITIES, AND THE MARKETS

The efficiency of the American capital market is legendary. While historically virtually every major city once had a stock market, at the present time the major markets are located in New York, Chicago, and San Francisco. Local markets persist (in Boston, Philadelphia, Cincinnati, Salt Lake City, Spokane, and Los Angeles) but those three are the big centers.

Capital markets are said to be efficient when they can match quickly vast numbers of stocks put forth by sellers with vast demands put forth by buyers. In part it is a matter of technology. The modern markets, particularly those in New York, rely heavily on computerization each day to process millions of transactions. But also, in part, it is a matter of tradition and experience. The stock market works largely on one broker's trust in another broker's word. The brokers, in turn, depend upon the faith of the customers they represent.

In a cynical era it is easy to overlook the importance of this institutionalized efficiency and breadth of fiduciary trust.

This chapter is an attempt to explain how the stock market works. In large measure it is written from the standpoint of the small buyer and seller of stocks. But it is not hard to see how these small customers are able to interact to provide a quickly responding market.

The principles of this market are similar to all others. For every successful buyer there has to be a successful seller. When more people wish to buy than to sell, the price tends to accelerate; when no one wishes to buy and many wish to sell, the price will plunge.

But it would be illusionary to assume that the market is without those who are willing to take advantage of the essential trust associated with the capital market system in the United States. For the better part of 40 years the federal government has played an increasingly important role in insisting on "clean dealing and unambiguous language."

Wall Street, New York City.

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So broad is the ownership of stock shares that owners can easily follow the fortunes of the market on a daily basis. One simply looks at the financial page of almost any large daily newspaper to see whether the indicators are up or down for leading stocks, or for a composite of the entire market. Beyond that, one can look at a specific stock and find the number of shares traded on the previous day, the high and low prices, and the closing price of the day.

Once a company has sold its original stock to the public and it is traded freely in the market, the price will be determined each hour of the trading day by what buyers will pay and what sellers will take. It is simply a matter of supply and demand. Thus, the price is the composite opinion of all the people who buy and sell that stock. Factors that influence how much people will pay for a given stock include: (1) the general business climate or trend (there are times when overpriced stocks sell well and other periods when good stocks sell poorly, depending upon the state of the entire economy and the amount of confidence the public has in it); (2) the amount of profit the company has been making or is predicted to make; (3) the rate at which the company is growing or declining; (4) the ability of a company to compete successfully with its rivals over a period of time; (5) whether the product is one that is popular, and whether the market for that product is growing or decreasing; (6) the general interest rate, or the market price for bonds; and (7) the return on alternative investments.

The Importance of Dividends

As we noted previously in a different context, when a company makes money it usually pays a part of its earnings to its shareholders in the form of dividends. An average payout is about 50 percent of the earnings. Thus, if a company made $20 million in a year and if there were five million shares of stock, this company might declare dividends in the amount of $10 million, retaining the other half for immediate operations and/or expansion. If there were five million shares of stock in this company, each shareowner would receive $2 per share. If one owned a hundred shares, the dividend would be $200. To carry the arithmetic a step further, if the stock sold at $40 per share and yielded a $2 dividend, the rate of return per share would be 5 percent.

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The Annual Report

Each year every stockholder receives an annual report on the company in which he or she has an investment. These annual reports are much different now from what they were 20 or 30 years ago. Previously, the typical report would be couched in generalities, telling the general health of the company, but not comparing it specifically with other years. Now virtually all major corporations give very detailed reports. They provide easy-to-read charts and summaries, usually giving a detailed report for a 10-year period. A certified accounting firm declares that the figures and statements about the finances are accurate. In addition to this information, company executives are required to disclose the extent of their holdings in the company. The entire process is supervised in amazing detail by the federal Securities and Exchange Commission (SEC).

The Stock Exchanges

While there are literally thousands of stocks, the ones bought and sold most actively are usually listed on the New York Stock Exchange (NYSE). This exchange dates back to 1792 when a group of stockbrokers gathered under a buttonwood tree on Wall Street in New York City to make some rules about how buying and selling was to be done. The NYSE has become the leading exchange in the United States.

The NYSE, housed in a large building on Wall Street, does the bulk of trading in listed securities. On the trading floor more than 2,200 common and preferred stocks are traded. The NYSE has 1,567 members, most of whom represent brokerage houses involved in buying and selling for the public. These brokers are paid commissions by the buyers and the sellers for executing the orders. Almost half a million kilometers of telephone and telegraph wire link the NYSE with brokerage offices around the nation.

In addition to the NYSE there are eight other exchanges around the country. The second largest is the American Stock Exchange (AMEX), which also has headquarter offices in New York City. Other exchanges of note include the Midwest Stock Exchange in Chicago and the Pacific Exchange in San Francisco and Los Angeles.

How are stocks bought and sold? Suppose a widow in

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California wants to go on an ocean cruise. To finance the trip she decides to sell 100 shares of her General Motors stock. The widow calls her stockbroker and directs him to sell at once at the best price he can get. The same day an engineer in Florida decides to use the savings he has accumulated to buy 100 shares of General Motors stock. The engineer calls his broker and asks him to buy the stock at the current price.

Both brokers wire their orders to the floor of the New York Stock Exchange. The two brokers, one representing the widow and the other the engineer, negotiate the transaction. One asks, "How much do I have to pay for a hundred shares of General Motors?" The highest bid is $65.25 and the least amount for which anyone has offered to sell is $65.75. Both want to get the best price, so they compromise and agree on a buy/sell at $65.50.

The NYSE itself neither buys nor sells stocks; it simply serves as a place where brokers buy and sell for their clients. Each transaction is carried out in public and the information is sent electronically to every brokerage office of the nation.

Over-the-Counter Stocks

The largest security market in the world in terms of the number of different stocks and bonds traded is the Over-the-Counter (OTC) market. OTC is not located in any one place, but is primarily a communications network of stock and bond dealers. These stocks are supervised by the National Association of Securities Dealers, Inc., which has the power to expel companies or dealers believed to be dishonest or insolvent. The financial sections of most large newspapers list asking and bid prices for many of these stocks. A brokerage house handles purchases and sales of these stocks along with those on the major exchanges.

Many persons who do not feel qualified to decide which stocks to purchase or when to buy and sell them turn to mutual funds. A mutual fund combines funds of its shareholders, which may be in small amounts, and invests them in a portfolio of stocks. The portfolio is diverse, thus limiting the risk, which is another reason why many people prefer this method of investing in stocks.

Another advantage of mutual funds to the customer is that he or she gets professional advice from staff analysts.

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It is possible for a fund to employ such persons because the operation is on a large scale. Some mutual funds began to fall from favor in the 1970s when their records turned out to be no better than those of other investors.There are dozens of kinds of mutual funds. Some are designed for income, some for capital appreciation, and others are speculative with the chance for large gains or severe losses.

Buying Stock on Margin

Americans buy almost everything on credit, and stocks are no exception. Usually an investor can make a stock purchase by paying 50 percent down and getting a loan on the remainder. This is called a "margin" of 50 percent. The balance is borrowed from the brokerage house and the stock certificates are deposited with the broker as security. The Federal Reserve Board regulates the minimum margins, the amount that must be paid in cash as a percentage of a purchase. The minimum margins vary, depending on whether there is need to stimulate the market or curb its speculative enthusiasm.

If an investor sells stock held on margin that has appreciated, the investor may pocket the profit and pay the broker the amount that was borrowed plus interest and commission. If the stock goes down, the broker issues a "margin call," and the investor is required to pay an additional amount into the account. If the owner cannot produce cash, some of the stock is sold at the investor's loss.

Buying stock on margin gives speculators (traders willing to gamble on high-risk situations) the opportunity to extend the scope of their operations. Their available cash will buy many more shares, giving them the opportunity of making more profit and also the risk of suffering greater losses.

At times the Federal Reserve Board requires a 100 percent margin, meaning that all stock must be paid for in cash. During the 1950s, for example, the margin rate varied from a low of 50 percent to a high of 90 percent. A low rate, of course, stimulates stock buying, while a high rate discourages it.

The first concern of most investors is the safety of their purchases. If necessary they will often take lower dividends to avoid great risk. In contrast, speculators hope to see the price of their stocks go up, usually within

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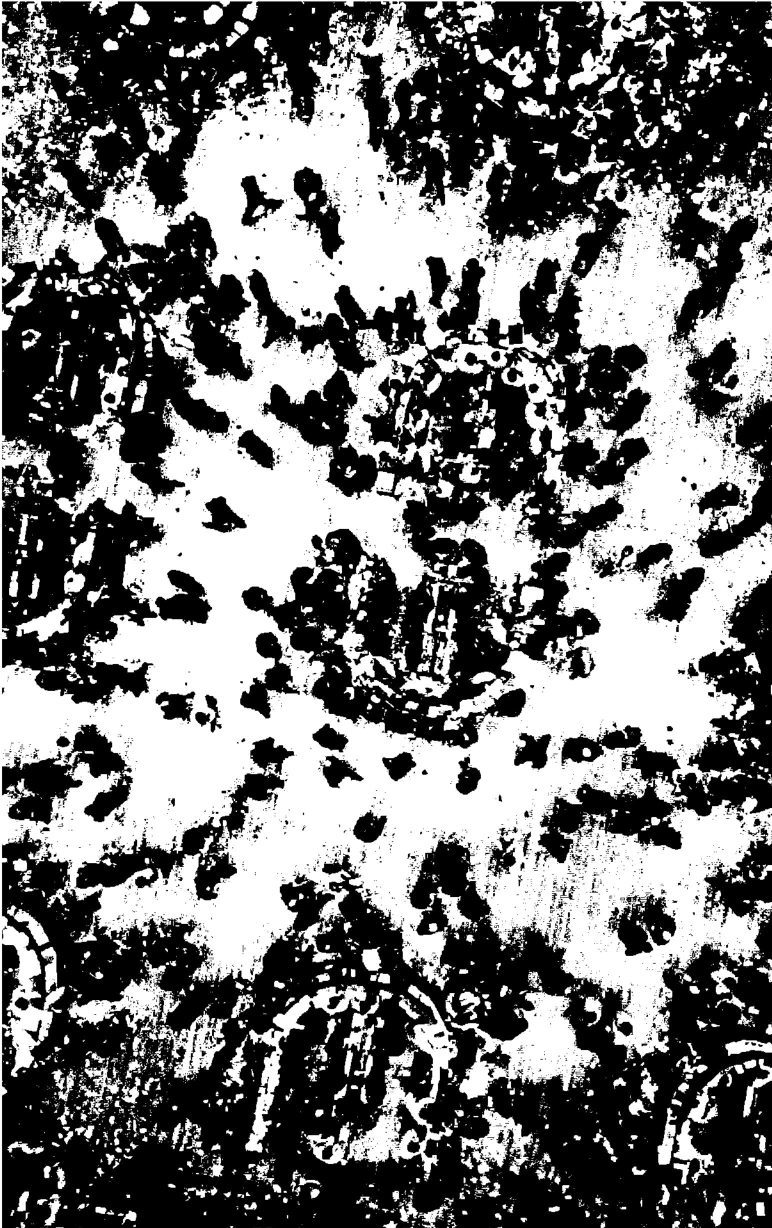

Frenzied activity characterizes the floor of the New York Stock Exchange on Wall Street, where representatives of buyers and sellers negotiate the price of stocks.

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months, or even days. They are more interested in the future of the stock than in its earning power at the time of purchase. People who believe they can outguess the market try to buy before prices rise and sell before they fall.

Commodities Futures

Commodities (metals, crops, livestock, etc.) tend to fluctuate in value from one season to the next. Commodity traders fall into two broad categories: hedgers and speculators. Hedgers are business firms (or individuals) that enter into a commodity contract to be assured access to the commodity at a guaranteed price. A firm secures a needed commodity and is protected against price fluctuation. Thousands of individuals, in contrast, trade in commodity futures as speculators.

There are at least two basic reasons for the ever-increasing interest in commodity speculation: (1) huge profits (or losses) can be made on small or thin margins; and (2) the almost uncontrolled forces of supply and demand in the world can send these prices up or down very rapidly.

Speculating in commodities is done primarily on a commodities exchange. There are a dozen such exchanges in the United States. The Chicago Board of Trade is the largest center for dealing in commodity futures. Under federal law passed in 1974, the Commodity Futures Trading Commission imposes somewhat stricter regulations on all trading than in the past.

How does the system operate? Suppose a person bought a standard contract for 30,000 kilograms of cocoa. This buyer could pay the money and have his cocoa delivered. Or the buyer could make the purchase and then sell the contract to someone else. Most people have no need for that much cocoa nor do they have a place to store it. Their purchase is purely a paper transaction; they hold the contract with the intention of selling it to someone else.

Commodity futures contracts, like stocks, are traded on margin. The difference typically is that a commodities margin is only about 10 to 20 percent of the value of the cost, which increases the opportunity for speculation.

Those who make money are often professional traders, well versed in the way the market is likely to react. It is estimated that of all small buyers who enter this

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Over 1,500 individuals process the investments of millions of people in more than 2,200 stocks. On September 30, 1980 the Exchange listed a total of 32,800 million shares worth 147,603 million-dollars.

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market, 85 percent lose money. In practice this statistic suggests a few very large winners and a great many losers. The risks are high because a small price change raises or lowers the profits dramatically. Often there are no buyers in a declining market. If, for example, the price of cotton drops two cents a kilogram on a given day and a person has a standard contract for 50,000 kilograms, his loss for that day has been $1,000.

Market Dynamics

Markets in stocks and commodities form a vital part of the American economic system. Millions of individuals buy and sell small lots of stocks and commodities while mutual funds and trusts trade in large lots. In good times, when it appears that prices will rise, money from savings or from other types of investment comes into the market. When this happens, prices are driven higher. Often a period of speculation follows in which the "bulls," those who make money on a rising market, are in the ascendancy. When the market can no longer sustain the speculative fever, a reaction sets in, selling develops, and prices begin to fall. At this point the "bears," or those who make money in a falling market, are fortunate.

During this process the Federal Reserve Board may be trying to curb excesses and stimulate or dampen the market by raising or lowering the margin. The flurry of buying and selling also creates temptation for insiders to try and manipulate the market in a given stock. While this illegal activity was once commonplace, it happens less frequently now, owing to active policing by the SEC.

A new factor of significance in the market is the volume of funds from abroad that is being invested. Not only has Arabian oil money made its way into American securities, but many people in Europe, Japan, and in other parts of the world as well, feel that their best opportunity for securing their wealth is to invest in American stocks.

One might ask why speculation is permitted when there is so real a danger of loss. The basic reason is that speculators can perform useful functions in the economy. Buying a commodity or stock in the belief that prices will rise speeds market equilibration and encourages faster entry of more suppliers. If the price change lagged until after

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an actual commodity shortage had occurred, the fluctuation would probably be sharper and more sudden. Remedial supply action could be further delayed. Similarly, if speculators foresee a surplus in some commodity, their selling of futures will help drive the price down to some extent before the surplus actually occurs. When speculators foresee a shortage and bid up the price, they are also helping to conserve the present supply. As the price goes up, less of the commodity is purchased; a rise in price encourages users to economize. Similarly, a lowering of price encourages users to buy more, thus helping to sell the surplus which is developing.

The Securities and Exchange Commission

The Securities Act of 1933 and the Securities Exchange Act of 1934 were designed to help protect investors, not only from fraud but also from the problems of misunderstandings associated with inadequate or unusual data-reporting. Enacted during the Depression, these laws and others passed in subsequent years are administered by the Securities and Exchange Commission (SEC), which consists of five members appointed by the President of the United States.

The general role of the SEC is to police the stock exchanges. When there is reason to believe that a corporation is hiding some aspect of the truth about its business, or when a company appears to be financially shaky, the SEC may require the stock exchange to furnish detailed information on the company. Another major function is to prevent manipulation of the price of a stock on the market. The Commission also regulates interstate market securities and enforces laws against unfair and illegal practices.

A corporation issuing new stock for sale to the general public must (1) register the issue with the SEC and (2) file a detailed financial statement (prospectus). This information, which must be made public, is designed to prevent prospective buyers from being misled. The SEC also requires companies to provide for the public information on how many shares of their stock are being bought or sold by officers of the company. The SEC believes that, because these persons have privileged information about the com-

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pany, their buying or selling can indicate to other investors their confidence in the future of the company. The laws have had some success in preventing fraud and secret dealings aimed at manipulating stock prices.

Another major function of the SEC is to keep a registry of the exchanges, brokers, and dealers that conduct Over-the-Counter securities business in interstate commerce. To obtain registration an exchange must agree to expel, suspend, or take other disciplinary action against any member who conducts business in a manner inconsistent with just principles of trade.

In its recent history the SEC has taken on the responsibility of overseeing corporate policies, particularly by requiring reports designed to uncover illegal company payments to political figures or to others for the purpose of buying their influence in steering new business to the company. What may be common business practice in many countries is in some cases unlawful in America. Congress has charged the SEC with seeing that American corporations abide by American business ethics even when doing business in another country. The SEC is one example of an agency created to protect the American public through regulation of business enterprise. Other such agencies will be discussed in the following chapters.

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SERVING OR PROTECTING THE CONSUMER

Much of the interest brought to bear on economics focuses on the production process. However, the purpose of production is ultimately consumption. And what do we know about the consumer?

The invariable legend is either that the consumers are sovereign—their demand steers the allocative process—or that they are at the mercy of the producers in the market, who manage them through subtle advertising, denial of choice, and price manipulation.

The truth, as usual, lies somewhere between. Over time, the consumer does have some influence on what the market produces. Abraham Lincoln, discussing voters' susceptibility to political manipulation, commented, "You can fool some of the people all of the time; you can fool all of the people some of the time. But you can't fool all of the people all of the time." So it is with market manipulation by producers. There are those who can be manipulated easily all of the time; there are even some periods when everyone seems to be manipulated; but over the long term most consumers usually work themselves loose from exploitation.

This chapter focuses on the evolution of the governmental role as it relates to consumer protection. It is not a very old role; indeed, the initial Food and Drug Act was passed in this century. Originally it depended entirely on honest information from the producers and the self-interest of the consumer. More recently, particularly in the recent amendments to the Food, Drug and Cosmetic Act, reliance is put on inflexible rules of controlled product testing. In the 60 years between those two laws, consumer protection moved from a mechanism for making sure that consumers were aware of the implications of their choices to one designed to keep consumers from making what are believed to be essentially dangerous choices.

American interest in consumer protection has changed and quite likely will continue to change. For the present, however, the emphasis is on keeping the consumer from acts of folly.

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The American consumer has almost an infinite choice of ways to spend money. While most people have limited purchasing power, they are nonetheless confronted by thousands of advertisers and salespersons wanting to sell them products.

When consumers spend money, they help decide which goods will be produced, as when purchasers of a new model of car influence an increase in automobile production. About 3,000 separate items are included in the average consumer's purchases for a middle-class household.

The shifting demands of consumers are a constant source of concern to business, which must produce in advance of purchases and estimate prices and inventories. Of course, these same business people try to influence the demand by advertising and other sales methods.

Consumer Savings

So far, we have concentrated on the consumer as a spender of money, because most income is spent for personal consumption. However, some disposable income (that part of a paycheck remaining after taxes are subtracted) is put into savings, and so each consumer can also be a saver. In other words, most people put most of their money into a checking account at the bank, but they also put some into a savings plan. Here are some popular ways of saving:

(A) *Savings Institutions*. There are three primary types of savings banks: (1) savings-and-loan associations, which make loans on real estate, (2) savings departments of commercial banks and (3) credit unions. Individuals who deposit their savings in banks receive a small annual rate of interest. Credit unions are non-profit, owned by the investors who may also borrow from them.

(B) *Life Insurance*. Some life insurance policies offer a form of saving as well as providing economic protection for the family in case the breadwinner should die or be disabled. The cost of a policy depends upon the age and health of the person insured and the type of policy. Straight life and endowment policies, once fully paid up, give protection throughout the life of the insured person and normally have a cash value; that is, the policyholder

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need not die to receive benefits. In a life insurance policy, one or more persons is named as beneficiary to whom the insurance will be paid upon the death of the insured.

There is a type of policy called term insurance that does not contain a savings feature. Term insurance is cheaper but offers protection only for the term for which premiums are paid and provides no additional benefits.

A fast growing method of distributing life insurance is through "group policies," bought jointly by the employees of a business, a labor union, lodge or club. A medical examination, always required for an individual policy, is not usually required under group policies. Premiums are lower because less paperwork is required and because profit per unit can be less owing to the larger volume.

About four of every five American families have some kind of life insurance for which they collectively pay annual premiums in excess of $30,000 million. The company keeps enough cash to pay claims and invests the remainder. Profits are made from the investments. Indirectly therefore, those who buy insurance become investors.

(C) *Pension and Social Security*. Most union contracts with employers provide for retirement benefits in the form of pensions. All employees of the federal government also have generous pensions, as do managers in most businesses. Prior to 1976, persons who moved from one company to another usually lost their pension benefits. Now, because of a law enacted in 1976, employees who move to another employer are permitted to transfer pension funds or keep their pension rights from the company they are leaving. Self-employed persons can establish tax-deferred retirement funds as well.

The Social Security system, begun in the 1930s, provides that employers and employees contribute a percentage of the employee's wages, with a stated maximum, into a federal retirement system. Coverage is widespread and permits most employed persons to retire with at least a minimum standard of living. Most private pension funds are designed to supplement Social Security benefits.

(D) *Stocks and Bonds*. Individuals may save by investing in stocks and bonds, including various types of government securities. These have been described in a previous chapter.

(E) *Real Estate*. The most important method of saving

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by individuals in recent years has been real estate investment, particularly in private dwellings. Most individuals buy these dwellings on a long-term basis, with a mortgage at a fixed interest rate. Interest and repayment of principal are combined in the regular mortgage payments and the homeowner saves the equity he builds up in repayments.

Short-Term Consumer Credit

Here are several forms of consumer credit available to individuals or families:

(A) *Charge Accounts*. Most retail stores extend credit privileges to their regular customers, charging them monthly instead of with each purchase. This short-term

The world of modern banking: (clockwise from upper left) currency and coins, credit cards, bank statements for customers, safe deposit boxes, checks, telephone for direct bill payment, computer tape and automatic teller window.

credit does not require payment of interest. In many instances long-term credit may be established with interest payments, so that payments for larger purchases may be spread over several months.

(B) *Charge Cards*. In recent years charge cards have been issued by petroleum companies, rental car agencies,

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travel companies, and banks, among many others doing business with a variety of customers. A host of credit card companies have sprung up, offering consumers the opportunity to buy on credit from a wide range of stores and restaurants. Among the most widely used cards are *American Express*, *VISA*, *Diners Club*, and *MasterCard*.

Owners of such cards must exercise care not to lose them, since they might be misused by others. Owners countersign purchase slips which merchants are supposed to check against the signature on the card.

These charge accounts and cards are used by some purchasers because they do not have enough money to pay cash. More often, however, credit purchases are made purely for convenience, to avoid carrying large amounts of cash, and to provide a record of purchases.

(C) *Installment Buying*. Most major purchases by American consumers are on credit. Usually repayment is made in monthly installments. A very low percentage of automobiles, for example, is bought for cash. Installment buying has become an integral part of the economic system. The item purchased serves as security, or "collateral," for the loan and can be repossessed by the seller if payments are not made as promised.

Consumer Aids

The alert consumer has a number of resources at his or her command when choosing goods and services. Some of them are:

(A) *Advertising*. Merchants inform consumers of products, their uses and prices through advertisements they place in the media. Advertising is especially important in today's large-scale national market because "word-of-mouth" knowledge about products is impractical. Businesses find advertising useful because it enables them to differentiate their products from those of their competitors.

In 1979, businesses in the United States spent almost $50,000 million on advertising. Advertising is considered a normal business expense, not unlike research and development, or product safety.

Although advertising performs some useful functions, critics argue that consumers are often enticed into buying things they do not want or need. They note that ads are

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prepared by experts who appeal to psychological desires and unconscious needs of prospective consumers. They also claim that the familiarity of the public with a brand name, or the amount of money a particular company spends to advertise its products, may be significant in terms of sales but is not necessarily reflected in the quality of the product advertised.

(B) *Consumer Testing Organizations*. Several private organizations test thousands of products and publish the results. They explain usually how tests were made, list brand names, and present relevant and comparative information. Products are usually classed according to which have the best quality, which are acceptable, and which are to be avoided. Individuals can subscribe to these services for modest annual fees.

(C) *Labels*. A shrewd consumer makes a practice of reading labels on products. Federal regulations require an accurate description of the contents of products and a statement of how to use them. Misleading statements are prohibited.

(D) *Warranties*. Many products have warranties or guarantees. For example, if a television set breaks down within a given time, perhaps a year, the manufacturer's warranty may offer to repair it or provide parts without charge. Some warranties limit the kinds of defects they will cover.

(E) *Better Business Bureau*. Almost every large town and city in the United States has a Better Business Bureau. While this organization is principally used by business people to ascertain credit ratings, it can also be used by consumers to report fraudulent businesses.

Consumer Protection Laws

Legislators at both the state and federal levels have been responding to constituents demanding increased protection for consumers. Here are some landmarks among the array of legislation in the field.

(A) 1906—*The Pure Food and Drug Act*, prohibiting mislabeling of the contents of food, liquor and medicine.

(B) 1907—*Agricultural Meat Inspection Act*, providing for federal inspection of meat-packing plants engaged in interstate shipment of meat.

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(C) 1938—*Food, Drug and Cosmetic Act*, strengthening food labeling requirements and extending controls over advertising and labeling.

(D) 1966—*Child Protection Act*, followed by the *Toy Safety Act*, assuring that toys are not poisonous, flammable, or potentially hazardous in other ways.

(E) 1968—*Consumer Credit Protection Act* (the "Truth in Lending" law), requiring lenders to disclose the true annual interest rate on loans and prohibiting businesses from sending credit cards to persons who do not order them.

(F) 1975—*Consumer Product Safety Commission*, protecting consumers from dangerous, faulty, or misleading products; and requiring companies to inform and educate consumers about the safe use of products. (All states and many cities and counties have agencies that deal with consumer complaints.)

Federal Trade Commission

Of the several federal agencies that protect the consumer, the major regulatory agency charged with this responsibility is the Federal Trade Commission (FTC). We shall look briefly at its history, purposes, and functions.

The FTC was created in 1914 by an act of Congress, which has been amended many times in subsequent years. The FTC is empowered to prevent "unfair methods of competition" and "unfair or deceptive acts or practices" by businesses.

The FTC was organized as an independent administrative agency in 1951, which means that although the commissioners of the FTC are appointed by the President (with Senate approval), the Commission is not supervised by the President. The agency has no explicit authority to punish offenders; its function is to prevent abuses through what are called "cease and desist" orders. However, for violations of Commission orders, the FTC may ask the Justice Department to go to court and seek civil penalties of up to $100,000.

One of the recent and most significant additions to the FTC is the Bureau of Consumer Protection. This branch serves as an advocate for the consumer, and provides information to the public on consumer protection and re-

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straint of trade and assists consumers in registering complaints.

In recent years citizens groups have favored expanding government efforts on behalf of the consumer by establishing a much larger Consumer Protection Agency with expanded jurisdiction and powers. Congress has not seen fit to enact such legislation, largely because of countervailing pressures from business to reduce what they see as the excessive burden of government regulation.

Food and Drug Administration

Another important government agency charged with protecting the consumer is the Food and Drug Administration. In 1883 Dr. Harvey W. Wiley, Chief of the Bureau of Chemistry in the U.S. Department of Agriculture, assigned some staff members to study problems of impure food and harmful drugs. He found "cure-all" medicines that were mainly alcohol, special medicines to quiet babies whose main ingredient was opium, and dangerous drugs sold to cure headaches. But it was not until 1906 that Congress passed the Food and Drug Act, which prohibited interstate sales of misbranded and adulterated food, beverages, and drugs. By 1933 the FDA had brought action in more than 232,000 cases involving mislabeling or harmful drugs.

In 1938 the Federal Food, Drug and Cosmetic Act, which retained the authority of the 1906 act, extended coverage to cosmetic and medical devices, requiring new drugs to be proven safe before marketing, authorizing factory inspections, and giving the FDA the power to seek court injunctions to seize unsafe products and prosecute violators.

By 1980 the FDA employed some 7,800 persons and spent a budget of more than $321 million. The FDA regulates industries whose products are estimated to value between $393,000 million to $487,000 million a year. Consumers are now invited to report any apparent violation of law.

Summary and Conclusion

Consumers' choices can be influenced by many factors; consumers' desires are constantly shifting, depending

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on their needs and on styles that have caught the popular imagination. Consumers are courted, enticed, and implored by sellers of goods and services. Various government agencies have been assigned the task of seeing that competition for consumers' business is fair and honest, and that the public is protected from false advertising or unsafe products. To achieve this end new regulatory agencies have been created and existing ones have been strengthened.

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THE INCREASING ROLE OF GOVERNMENT

We have seen in the previous six chapters that, whatever else it is, the American economy is a combination of certain reasonably straightforward, theoretical principles and a myriad of complex institutions. In the beginning we stressed that in principle America has never been particularly ideological with regard to economic matters. True, there are ideologues in our midst who assert that America is traditionally the home of free enterprise, and that governmental intervention is a recent wicked importation from abroad, particularly from socialist countries. But such assertions are historical nonsense; there is a strong tradition in America of reliance on governmental activities—on the federal level, on the state level, and certainly on the local level.

In recent years there has been a great deal of explicit reliance on governmental efforts to meet the economic needs of the poor and disadvantaged, and investigation of economic producers' combining their operations. And just as it is nonsense to assert that the United States has a history of freedom from economic governmentalism, it is also nonsense to assert that the nation is suddenly discovering that economic problems have very profound political ramifications. This chapter, however, discusses the level of governmentalism that has been emerging in the last decade. There is no doubt that governmental intervention in economic matters is quite widespread at present. It is certainly widespread compared with governmental intervention at the time Thomas Jefferson was President in the early 1800s. But it is not particularly widespread in comparison with 40 years ago. What has changed, however, is the awareness that the nation is not going to be able to return to some mythical historical state where only individualistic and market decisions are made in the resolution of social and economic problems.

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In the previous chapter we began to see how the government's role has increased as the economy has grown in size and complexity. Strong government regulation and direction now balance the power of big business and labor. The government has assumed this larger role as the result of problems inherent in growth and success, including the need to control monopolies and the urgent requirement to protect the environment. Additionally, a new type of economics has led the government to take an active role in the management of the economy and the welfare of its people.

Federal Attempts to Control Monopoly

The United States went through a period of rapid trust formation at the end of the 19th and the beginning of the 20th centuries. Small companies merged into bigger ones. Big companies, with no regulation, entered into agreements to limit supply and raise prices. Often they drove weaker ones from business by cutting prices and taking losses until competitors went bankrupt. Then the survivors could take over assets of their former competitors and raise prices.

In 1890 the Sherman Antitrust Act was passed by Congress, making it illegal to monopolize trade or to combine and conspire to restrain trade. On paper it was a step forward, but in practice the act seldom lessened monopoly.

Then, in the early 1900s, during the administrations of two Republican Presidents, Theodore Roosevelt and William Howard Taft, the government began to apply the provisions of the act to prevent monopoly. As part of this change, the Supreme Court prevented the merger of two giant railroads, owned principally by J.P. Morgan and E.H. Harriman. Later, the Court ordered Standard Oil Company broken into a number of smaller companies. At the same time the Court defined the guidelines it would use in applying the Sherman Antitrust Act. Only "unreasonable" restraint of trade would come within the scope of the act and be considered illegal.

The Clayton Antitrust Act of 1914, in addition to excluding labor from antitrust action, tried to define more clearly what was meant by restraint of trade, and therefore, what was illegal. The Federal Trade Commission Act of

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1914 extended the power of the federal government to police economic competition.

The United States Steel Company was accused of monopoly practice for operating as a price leader in the steel industry. A suit was brought in 1912 which was carried through the courts and was not finally settled until 1920. Then, the Supreme Court, in a landmark decision, held that U.S. Steel was not a monopoly, and a careful distinction was drawn between bigness and monopoly.

Over the past 35 years government has been active in its antitrust prosecutions. Three important examples give evidence of the scope of these efforts: (1) In 1948, in the Portland Cement Case, the Supreme Court's ruling abolished the system under which quoted prices included ''normal'' freight charges from a specified location regardless of the actual cost of transportation from the plant involved. (2) In 1957 the Supreme Court ruled that the Du Pont Company had to divest itself of its shares of General Motors stock because Du Pont's major interest resulted in domination of General Motors. (3) In 1961 the electrical equipment industry was found guilty of fixing prices in restraint of competition. The companies agreed to pay extensive damages to consumers, and some corporate executives went to prison for the illegal planning of price fixing.

The Regulators: Watchdog Agencies

There are now more than 100 federal regulatory agencies to which Congress has delegated power. These agencies all have one thing in common—they are designed to protect the public interest. The operations of regulatory agencies are influenced by the executive and legislative and judiciary branches. Agencies are directed by commissioners or boards with the stipulation that the two major political parties be equally represented. Commissioners are appointed by the President and confirmed by the Senate for a fixed term, usually five to seven years. Congress oversees the way they spend funds appropriated to the agencies, and the courts review any disputed decisions. Each agency has a staff, often more than 1,000 persons.

To the uninformed outsider it may appear that the agencies perform mostly the function of courts. Agencies hold hearings that resemble court trials when officers of

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corporations or others are accused of violating policies. As in courts, the defendants are represented by lawyers. Whatever ruling the agency makes is subject to review (and possibly reversal) by federal courts. Each year the agencies collectively issue more than 100,000 rulings, far more than all federal courts. The great majority of these rulings are not disputed by the parties involved.

The agencies are isolated by law from the President and from partisan politics. Critics of regulatory agencies have charged that its members are sometimes pressured by members of Congress on behalf of their constituents or influenced by the business interests they are supposed to regulate. In addition, agency officials acquire intimate knowledge of the businesses they regulate, and some officials are offered high-paying jobs in those industries once their tenure at the agency is ended. Laws have been proposed to discourage questionable relationships between businesses and regulators.

Environmental Protection

The U.S. Environmental Protection Agency (EPA) was established in December 1970, bringing together in a single agency the many programs of government related to environmental control. Creation of the agency climaxed years of public debate over how to protect the health and welfare of citizens from the unwanted and hazardous effects of an industrial society.

Some Americans vigorously protested lack of control over automobile exhaust fumes, industrial smoke, unhealthy open dumps, untreated sewage, and chemical wastes that were being thrown into lakes and rivers. The agency was created to control and abate pollution in the basic areas of air, water, solid waste, pesticides, noise, and radiation.

EPA employs more than 12,000 persons and spends more than $5 million annually. Through its Washington, D.C., headquarters and regional offices, EPA offers incentives to encourage cleanup efforts, and law enforcement when necessary to curb pollution.

The agency conducts extensive research, provides technical assistance to states and cities, determines tolerable limits of pollution, and establishes timetables to bring

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polluters into line with standards. Since most of the requirements are of recent origin, industries are given reasonable time, often several years, to conform to standards. Monitoring data show a nationwide decline in at least two air pollutants—carbon monoxide and sulphur oxides. Current auto emission controls resulted in a reduction of carbon monoxide and hydrocarbons of nearly 85 percent over cars made before 1968. EPA also enforces noise standards for trucks and airplanes.

The Influence of Keynes

We have previously discussed how government has attempted to regulate trade and its effects, as well as various parts of the economy. But what of the economy as a whole? Only relatively recently has the government begun to take an active role in the overall management of the economy.

Much of the impetus for this involvement results from the influence of John Maynard Keynes, an English economist who developed a way to analyze and explain depressions. American economics has been greatly influenced by his approach. Keynes noted the interrelationships among income, savings, consumption, investment, and interest rates, and believed that the amount of private investment taking place in an economy dictates whether or not the system stagnates or expands. Keynes was one of the first to argue that it was the special duty of government to influence the economy actively through supplementary investment.

He saw government spending as the primary instrument for meeting the twin goals of expansion and stability. Depressions could be avoided largely by a deliberate fiscal policy of increased government spending or by enlarging the national debt through reduced taxes. (A much-ignored Keynesian corollary was that, in boom years, national government surpluses should be provided for debt retirement.) In essence, this new economics says that the economy is like a machine. Whether it runs down or speeds up depends on whether it is fed more or less fuel by the people who direct it.

Many of Keynes's ideas were included in President Franklin D. Roosevelt's New Deal program, instituted in

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the early 1930s. After World War II, Keynes's full-employment policies were accepted by the United States, along with many other nations. His influential work *The General Theory of Employment, Interest, and Money* (1936) seemed to revolutionize economic thinking. During the Great Depression of the 1930s, Keynes said that nations should "spend their way back to prosperity." He believed the unemployed should be put to work and that incomes should be redistributed so the poor could have money to spend.

This perspective on how to deal with the economy proposed a much larger role for government than had been acceptable up to that time. Since the 1930s the cleavage dividing American economists often has been related to the extent of validity they are willing to accord the Keynesian analysis.

The Budget-Making Process

The federal budget provides an analysis of income that is expected and a detailed plan of spending for the forthcoming year. It is prepared under the supervision of the President, then submitted to Congress for modification and approval. The budget is enacted into law to legalize the collection of revenues and the expenditures of funds. Budget accounts are maintained by the Department of the Treasury and are audited at the close of each year. Except for areas of sensitive national security, all citizens have the right to review the audits and inspect how public funds were received and spent.

The successive stages in budgeting are known as the budget cycle: preparation, authorization, execution, and audit. The budget is designed to indicate major categories of revenue sources such as personal income tax, *ad valorem* sales tax, and business tax. Expenditures are listed by government departments and agencies, and often separately in broad terms such as amounts for health, national security, education, etc. The document also shows the amount requested by each program as compared with the amount actually authorized by Congress. These amounts are listed for three years so that anyone reading the budget can get a sense of the direction in which expenditures in a particular area are moving.

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Preparation of the budget is a complex political process. It begins almost a year in advance. First, an agency or department prepares its own request, showing the amount it needs to support its program. After review by the department head, the proposal is sent to the Office of Management and Budget (OMB), an arm of the Executive Branch. OMB, in turn, reviews the request in light of priorities and goals established by the President and compares the needs and requests of one agency with another.

Almost every agency in government makes strong bids for funds they want, often supported by special interest groups. The President makes the final decisions on how much to request from Congress for each program and what the total amount will be. The budget request reflects the economic policy of the administration. The President seeks to stabilize the economy by spending more or less money during the year. Stability is considered in terms of full employment, control of inflation and deflation, distribution of funds among various regions of the country, meeting needs of the poor, national economic growth, and a relatively balanced budget.

In 1974 Congress set up its own staff to advise it on budget planning. Generally, this new congressional discipline has been praised because it places ceilings on total spending and thus makes Congress pick and choose among desirable programs, rather than simply accepting every one regardless of total expenditures. This budget-making process permits Congress to establish its own national priorities which can then be negotiated with the President.

The initial detailed examination of the President's budget is made by the House Appropriations Committee. Through subcommittees, it holds hearings for each department and agency included in the budget. The requests for funds are defended in open sessions by officials of each agency. Hearings are often very detailed; members of Congress often question closely those who spend money.

An appropriations bill is then presented to the entire House of Representatives, where it is passed and sent to the Senate. The Senate Appropriations Committee holds hearings of its own and sends its recommendations to the full Senate. A committee from each body then meets to reconcile differences in the two budgets, item by item. The resulting bill is then enacted into law and sent to the Presi-

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dent for his signature. Should he veto the appropriations bill, it goes back to Congress. If two-thirds vote of each house approves the bill, it becomes law despite the veto of the President. If the necessary number of votes cannot be mustered, a new compromise appropriations bill will have to be worked out and voted into law. The total process for all agencies and departments of government is broken down into 12 to 15 different bills, each covering one segment of the total budget.

OMB has further control during the time the money is being spent. It may release funds on a quarterly basis rather than all at one time. Should there be a period of depression or inflation, the President may try to slow down or increase the rate of expenditure.

The budget process, then, is complex and comprehensive. It permits input and protest by citizens at many critical points, and it is always a compromise among the various interests and political philosophies of the citizens.

Council of Economic Advisors

When Congress passed the Employment Act of 1946, it declared that promotion of maximum employment, production, and purchasing power was to be the policy of the federal government. It authorized the President to appoint a three-member Council of Economic Advisors to study economic conditions and advise the President on needed action.

This act focused on full employment, but it did not specify just how the goal was to be achieved. The law recognized freedom and competition as important goals in themselves. The nation, the law stated, should rely on free enterprise, not on government direction of business, for running the vast economy.

This prestigious council advises the President on economic problems and helps set the tone of government policy as it decides what kind of action is required. The council has no direct authority, but keeps constant watch over changes in income, production, and employment. It recommends economic policy to the President and helps him prepare reports to Congress.

The Treasury Department is responsible for serving the fiscal and monetary needs of the nation. Created by

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Congress in 1789, the Treasury has always had responsibility for: formulating and recommending domestic and international fiscal and tax policy, participating in the formation of fiscal policies for the economy, managing the public debt, carrying out law enforcement related to taxes, serving as financial agent for the government, and manufacturing coins and currency.

While there are many facets to the duties Congress has given the Treasury over the years, three areas are singled out for comment and study, partly because they are representative, but also because of their importance.

(1) A major Treasury official is the Comptroller of the Currency, who is administrator of national banks. He or she is responsible for executing the laws governing the operation of approximately 4,600 banks. On a regular schedule each bank is examined by a nationwide staff of 2,000 bank examiners.

(2) The Treasury is responsible for the United States Customs Service, which regulates duties and revenues on imports. The Department collects and protects the funds received from Customs. It is also responsible for suppressing traffic in illegal narcotics.

(3) The Internal Revenue Service (IRS) administers tax laws, the source of most of the nation's revenues. Individual income taxes, corporate taxes, excise, estate, and gift taxes are all administered by the IRS; it also collects revenue on alcohol, tobacco, and other commodities that carry a federal tax.

The Treasury Department is deeply involved in setting policies related to international trade and global fiscal policy. At times it competes for influence with other federal departments and agencies in setting international policy. Treasury has always been an especially important department of government in controlling and enhancing the American economy.

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MONEY, BANKING, AND FISCAL POLICY

Since the mid-1950s economists as a group have been concerned about, even fascinated with, the prospect of controlling the economy by the use of monetary policies (affecting the supply of money and the velocity of its circulation) and fiscal policies (including tax regulations and governmental spending).

By the late 1960s these economists were using the term "fine tuning" to indicate the level of dexterity they believed they had in achieving the nation's principal economic objectives. They identified these objectives as economic growth, full employment, and price stability. But the economists suffered from *hubris*, a classical Greek term describing that peculiar form of man's pride that tempts the gods to destroy him. The economists' capacity to "fine tune" proved to be an illusion.

They tried to explain where they failed. In part, their explanation rests on the very obvious point that America is essentially a democratic society and the economic measures necessary for restraining inflationary influences were politically too unpalatable to be employed. In part, of course, the economists could have failed for other reasons. The most likely of these is the tremendous shocks to the American economy (as well as to the economy of the rest of the world) associated with the cartelized increase of petroleum prices starting in 1973. It is also possible that the effort failed because there are theoretical problems associated with forecasting the future. As one very important modern theorist states, "Reason and time are polar extremes." Reason is the path that at a given moment an economist (or any other person) believes events will pursue. Time stretches out into the indefinite future. There is an essential uncertainty about the future, and the capacity to "fine tune" is limited by man's control of events only for the immediate here and now.

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In this chapter we will try to explain how economists believe the American economy works. It is an exercise based on the assumption of reason. Economists, as a profession, clearly recognize that they are in no position even to predict human events, much less control them.

There is nonetheless a purpose in studying what economists think they can try to do. One does not have to settle for "all or nothing." In many instances economists have been able to do a good deal to help shape future events. Many people believe that economists are able to cope better with deflationary tendencies than with inflationary tendencies—not because economic theory is better in the former case and worse in the latter, but because in a society where the poor as well as the rich vote, and where the poor tend to outnumber the rich, policies aimed at ameliorating deflation are easier to put across than policies aimed at controlling inflation.

This chapter starts with a discussion of the operation of the banking system. Readers must remain aware that the United States covers a gigantic geographical area. Historically, the banking system has tended to be composed of a large number of local systems. After the disastrous events of the great stock crash of 1929, there was a movement to expedite the earlier tendencies toward a national system. Essentially, this chapter describes recent experience with the post-Depression banking system.

The chapter concludes with some discussion of contemporary problems of controlling inflation, solution for which is still a long way off.

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The accepted aims of American society have been full employment accompanied by price stability. When choices have had to be made between them, the employment goal has dominated. Both fiscal and monetary policies have been used in pursuit of these objectives. In this chapter we shall examine how money is created and used, how private banks operate, how the Federal Reserve System works, how inflation affects the economy, and how tax and government spending policies are important to a stable and prosperous economy.

The Place of Money in the Economy

Money is a medium of exchange used to measure prices and debts. Americans use three kinds of money. First, there are coins—the penny (one-hundredth of a dollar), the nickel (one-twentieth of a dollar), the dime (one-tenth of a dollar), the quarter (one-fourth of a dollar), the fifty-cent piece (a half dollar), and the dollar coin. These coins once contained silver and represented real value; now they have less-precious metal and have only symbolic significance.

The most important kind of currency is paper, in various denominations: ones, twos, fives, tens, twenties, fifties, hundreds, etc. Rarely, one may still find dollar bills with the words "Silver Certificate" on them. Such bills were once backed by deposits of silver and could be exchanged for the metal. By 1963 silver used in industry had risen in value to the point where it was worth more than silver coins, so many people began to melt them and sell the silver. At that point Congress dropped any pretense of money being backed by silver, either as coins or paper money.

Usually a paper bill says "Federal Reserve Note." It is considered "legal tender" for payment of all debts. The bills state that they can be redeemed "in lawful money" at the United States Treasury or any Federal Reserve Bank. These bills are money simply because the government calls them money and assigns a certain value to them. And when these bills are offered in payment of debt, they must be accepted.

Before 1933 American currency was on the "gold standard." This meant a person could go to a bank and

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exchange paper money for gold. In 1933 Congress raised the price of gold from $21 to $35 an ounce and required every citizen to turn in gold coins and bullion to the government. Only personal items such as gold watches, rings, etc. could lawfully be held. At the same time, paper money could no longer be exchanged for gold. In 1971 the price of an ounce of gold was raised to $38. Since that time the price of gold on the world market has risen by many times that value (to over $700 an ounce in 1980). In 1975 the government made it legal once again for U.S. citizens to own gold. Many expected a rush to buy bullion or some other form of the precious metal, but this did not happen immediately.

A third type of money negotiable in America is the check, or "demand deposit." A person pays for the purchase of an item by writing a check, which is then sent to his bank. Thereupon the bank honors the check in the amount indicated and removes that amount of money from the deposits in the person's account. A checking account can be regarded as money because one can pay for purchases with checks drawn on the account. That is, the check can be converted into cash at any time. Paying by check is a convenience permitting a person to do business without carrying cash. Further, the check provides a record for tax and business purposes. Checks are used far more widely than cash.

Money serves several purposes in society. A person converts assets into money to have an efficient medium of exchange. Barter is also used on occasion, but on a large scale it is hopelessly insufficient. Again, money is used as a unit of account to determine the value of goods and may be seen at times as the safest way to hold one's assets. The money hoarder trusts its value more than the value of stocks or the safety of banks. But in a sense, the person who keeps cash on hand pays for the privilege; if this individual chose to do so, he or she could earn interest on the money by investing it.

History and Present Status of Banking

Today almost 15,000 banks in the United States offer checking accounts. One-third of these are national banks; the remainder are under the supervision of the states. Ev-

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ery national bank is a member of the Federal Reserve System. This system controls the legal money supply. If printed freely, money would become worthless. That is why the government has constitutional power over money and banking, and why policy is always public rather than private. Since 1933 almost all commercial banks, state or national, have had their deposits insured by the Federal Deposit Insurance Corporation (FDIC). Each deposit is insured up to $20,000.

Until the last decade it was relatively easy to organize a bank. Because little regulation was imposed, these banks at times made unwise loans from which they were unable to recover losses. In times of depression the values of mortgaged items were no longer as great as the amounts owed on the mortgages. Hence many banks failed, and their depositors lost money. Almost half the banks in existence in 1915 are no longer solvent. During the Great Depression that began in 1929 some 650 banks, with estimated total deposits of $200 million, failed. Depositors recovered only a percentage of their money, all that could be salvaged. Since the establishment of FDIC, few banks have failed and their depositors have been reimbursed through insurance.

Banks perform two basic functions: 1) they offer depositors a place to keep their assets, either in a savings account, which pays interest, or in a checking account, which provides convenience; and 2) they accumulate money, which can then be loaned to individuals or businesses—these loans may be of short-term duration for family or business use, or they may be long-term in the form of mortgages.

Commercial Banking

Commercial banks are designed to make a profit for their stockholders. They receive money in the form of deposits, savings or repayments from the public, then lend it at interest to borrowers. Profit is made primarily from interest. Obviously, banks do not keep most of the money they receive; indeed, a bank will have on hand only enough to pay those customers who want to withdraw their money on a given day. A modern bank usually needs no more than 2 percent of its money in cash. Yet law requires

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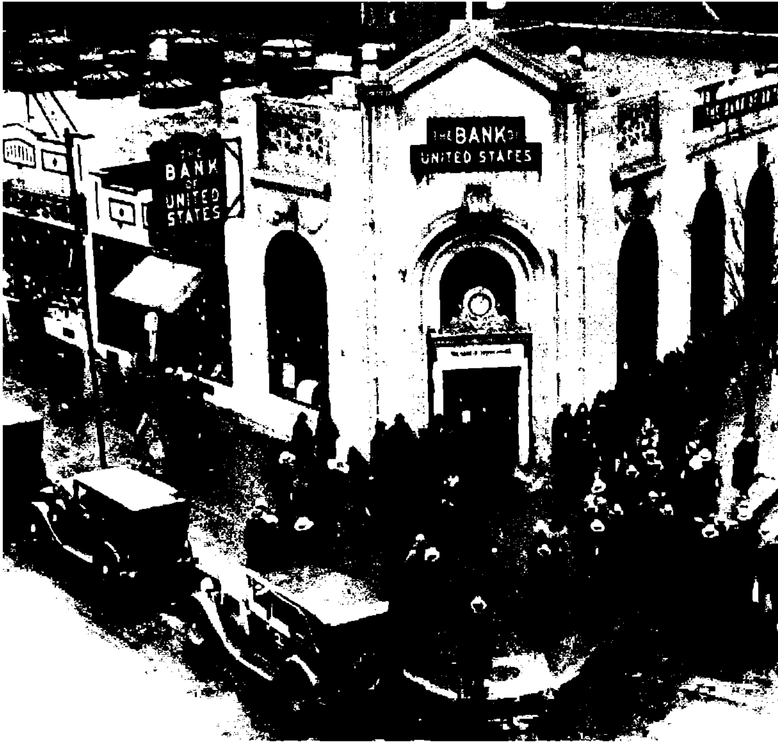

In New York City, bank depositors waited anxiously on Sunday, March 5, 1933, when President Franklin D. Roosevelt proclaimed a four-day holiday to end the run on banks and restore confidence in the economy.

this same bank to deposit a sixth or seventh of its resources in non-earning funds with the Federal Reserve Bank in its district.

To insure additional protection against a "run" in which withdrawals would exceed deposits, most banks buy government bonds called notes or certificates. These are short-term notes of from 90 days to one year. Reasons for owning bonds, whether short- or long-term, are: (1) they can be converted to cash quickly, thus providing liquidity, (2) they provide an income, and (3) they are a hedge against the changing value of assets.

If a bank really needs only a 2 percent reserve, why then does the Federal Reserve System require 15 or 20 percent reserve? The main purpose is not for safety of the

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deposits but to control the amount of money member banks can create. Let us see just how banks create money.

Expansion of Money by Banks

Banks are permitted to create money out of "multiple expansion of bank deposits." They generate about five dollars of new money for every dollar of reserves. Let us suppose that a person brings $100 into a bank for deposit. If the bank were to hold 100 percent reserves, it would keep the total amount in the vault. However, as we have learned, the law requires that only a small percentage be kept. Let us assume the amount required at this time is 20 percent. With the $80 that does not have to be deposited with the Federal Reserve, the bank may buy government bonds and lend the money, thus assisting business expansion, making mortgages on property, and the like. Note that the depositor still has $100 in the bank, but the bank, in turn, has created $80 of new money by lending it.

The person who borrowed the $80 will probably deposit some or all of the money in the same bank or in some other bank; what is not deposited immediately will probably be spent and subsequently deposited in another bank. Eventually then, the banking system receives a total of $80 in new deposits—the $80 that was borrowed from the first bank. As in the first instance, the other banks, referred to as second-generation banks, keep only 20 percent of the new $80, or $16, and loan out $64. And so it continues, as each later generation bank retains 20 percent and offers the new 80 percent for loan. Through this chain process, the banking system eventually ends up with total deposits equal to five times the original $100.

The Federal Reserve System

In 1913 Congress passed the Federal Reserve Act, dividing the country into 12 districts with a Federal Reserve Bank in each. A seven-member Board of Governors (Federal Reserve Board) in Washington, D.C., coordinates these banks, which in fact constitute a central banking system. As in other major countries, the central bank is set up by the government to handle its transactions, coordinate

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and control commercial banks, and help regulate the nation's money supply.

The Federal Reserve System is responsible directly to Congress, although by law the Governors are independent of political pressure from either Congress or the President. The Board is, of course, expected to coordinate its policies with those of the Administration and the Congress. When a conflict arises between making a profit or serving the public interest, the "Fed," as it is called, is supposed to choose the latter.

The Role of Federal Reserve Banks

The Federal Reserve is a system of banks for bankers, a government operated central bank. It has one main purpose: to control the supply of money and credit, including the total of all coins and currency in circulation, plus checking accounts. This control is exercised through "monetary policy." When business worsens, the Federal Reserve Board expands the amount of money and credit. But if prices start rising too rapidly, the Fed will do all it can to put on the brakes and reduce the supply of money and credit.

How? The first step is to require the nation's banks to keep a larger amount of their deposits on reserve. With less money to lend, credit becomes "tight." Tight credit causes less money to be available for prospective borrowers, thus increasing the rate of interest.

When interest rates go up, businesses do not expand so rapidly as before, families cannot afford to buy new houses or cars, and other forms of buying slow down. During a period of high interest, the customer is forced to make a larger down payment on his purchases. For example, when money is plentiful, the buyer of a $40,000 house would have no trouble getting a 90 percent loan, or $36,000. His cash outlay (down payment) would be only $4,000 plus legal expenses. But when money is in short supply, the bank will want to get the safest loans possible with limited money, so it may require a 25 percent downpayment. In that case, a prospective home buyer would need to pay $10,000 down rather than $4,000. Such a large cash investment would prevent many families from buying, thus slowing the rate of building houses and con-

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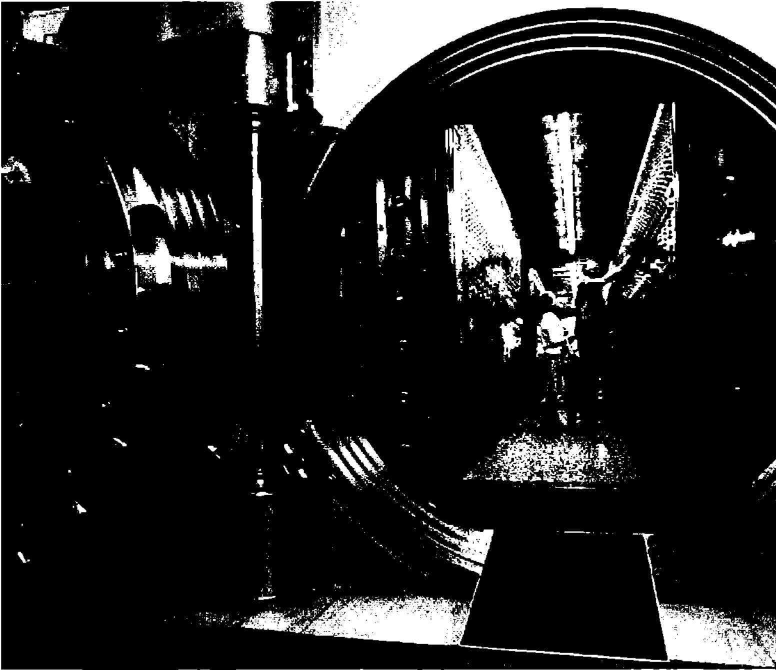

This fireproof bank vault contains many rows of safe deposit boxes, which people rent to store their valuables. The customer keeps the key and no one—not even a bank official—can open the box without the customer's permission.

tributing to a slowdown of the economy. When the Fed diagnoses the country as being in an inflationary period, it requires banks to increase their reserves as a way of slowing inflation. Finally, when the economy cools, the Fed reverses the process and makes more money available. Changing the amount of reserves required is a powerful tool that the Fed uses cautiously.

In addition to requiring a larger or smaller reserve for member banks, the Fed possesses two other weapons in its war against inflation or depression. First, it can go into the market and "buy" money, in what are called "open market operations." Usually this money is in the form of short-term bonds. Suppose the Fed thinks a depression is coming. The members meet and say, "Let's buy a thousand million dollars worth of government bonds from insurance companies, banks, and big business firms." These institutions are then free to invest the money they receive

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in exchange for the bonds. The bulk of this investment will be with banks. Thus, because of the chain process discussed earlier, the Fed will have created excess reserves for its member banks. More money becomes available for loans. So, the interest rates go down, and down payments decrease. With a 20 percent reserve requirement, one thousand million dollars spent in the marketplace would add up to five thousand million dollars of new money.

The way the Federal Reserve banks lend money to member banks constitutes the final weapon in the Fed's arsenal. These loans, called "discounts," carry an interest rate. By regulating the discount rate, or the interest banks pay to borrow from the Fed, they encourage or discourage borrowing. People who buy and sell stocks or bonds keep a close watch on the discount rate. Even interest rates and investment spending abroad are influenced by changing discount rates. These discount rates are usually tied to interest rates on the open market. In an effort to tighten or loosen credit, the Fed will raise or lower the discount rate.

The Trend Toward Higher Prices

One of the most disturbing aspects of the American economy in recent years has been the trend toward higher prices. Although this inflationary tendency can be plotted over the past 40 years, it has usually been accompanied by a higher standard of living. In the 1970s, however, the inflation rate was substantially greater and inflation is now considered one of the most, if not the most, pressing economic problems that Americans face. The monetary policies of the federal government are in large measure devoted to the alleviation of the problem.

Of course, there have been ups and downs in the prices consumers have paid for goods and services. A study of the graphs and charts prepared by economists makes it clear that prices peaked during each war, followed by declining prices in the postwar period. But in more recent postwar times the declines have been less sharp. In part, this has been true because government acted quickly to prevent depression. Beyond that, a general trend has been observed in which prices have risen in good times but have not fallen proportionately in bad times; the long-range trend for prices has been upward.

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Inflation and Deflation

The term inflation signifies a decline in the value of money, which implies a general increase in the prices of commodities and services. Deflation means the opposite—generally falling prices, usually accompanied by lower profits and fewer jobs.

Times of mild inflation are usually characterized by high employment, with factories producing near their capacities. Once full employment has been reached and factories begin operating at or near capacity, any additional increase in national spending will serve to drive prices higher at a rapidly increasing rate. The reason for this is that a relatively static amount of goods and services is being "chased" by an increased number of dollars.

Further spending increases or shortages in goods and services lead to rapid inflation. During such a period industries raise prices because their own costs are going up. They usually want to cover these costs and add a further amount for more profit. In turn, labor asks for higher wages to offset the increase in the cost of living, plus an additional amount. This upward spiral contributes to what has become known as "galloping inflation."

Such extreme inflation can lead to major disruption in the social order. A period of speculation begins in which persons buy property, stock, or commodities with the expectation that what they bought will increase rapidly in value. Such speculation can reach a fever pitch, with prices going even higher, until they are out of all proportion to real value.

In general, inflation tends to favor people who are in debt at the expense of those who lend money or who live on fixed incomes. For example, if you borrow $100 at 7 percent interest, you must repay $107 at the end of a year. If inflation has risen at a 10 percent rate of inflation, $110 at the end of the year is worth the same as $100 at the beginning. So you have profited by $3.

Those who live on social security or a fixed income find that the limited dollars available to them are buying less and less. These people are often hit the hardest by inflation because a higher proportion of their incomes goes to buy essentials: food, housing, and medical supplies and services. Some fixed-income or pension plans have built-in

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cost of living increases, but most do not.

In the United States, inflation averaged less than 1 percent yearly during the 1950s and about 3 percent in the 1960s. Since then, inflation has been considerably greater, averaging over 6 percent for 1970-77 with periods of severe, or "double digit," inflation at the end of the decade and into the '80s. One task the government has now assumed is to limit the impact of either depression or runaway inflation. Other than in wartime, the United States has usually tried to control these swings without resorting to wage and price controls. In addition to monetary and fiscal policies, one popular method used by Presidents to slow increased prices and wages has been called "jawboning," that is, making public speeches to apply political pressure to corporations and labor unions to act in the public interest. Similar tactics, as well as the limited power of the presidential veto, can be used against congressional spending proposals that are deemed inflationary.

Monetary and Fiscal Policy

We have seen that through its monetary policies government can try to control money to curb inflation, fight depressions, and provide full employment. By trying to control the amount of money in circulation, the government influences the amount of investment, savings, and expenditures that takes place in the economy. However, as part of its fiscal policy, the government can, if it so chooses, also expand or contract its own expenditures. It can build or refrain from building highways, military aircraft, schools, or a hundred other things for which it spends money. Because the government spends between 20 percent and 25 percent of the total Gross National Product on goods and services (excluding transfer payments), this spending or restraint will have a major effect on the condition of the economy.

When the government increases its level of spending, without raising taxes, it is pumping more money into the economy. During sluggish periods, this process can serve to heat up the economy, cause new investment, and create jobs. On the other hand, too much stimulus can aggravate inflation.

Because the government must borrow to get the mon-

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ey for these increased expenditures, thus adding to the already sizable public debt, there are those who favor another method to stimulate spending. This would be the lowering of income taxes. Suppose that the economy is slowing down. People have less money to buy new cars, houses, and other products, endangering the employment of people who make these things. Congress may order a tax cut, either temporary or permanent. The lowered tax will give people more money to spend. Instead of paying the government, they have money to buy goods and services. This puts more people to work providing such products, which, in turn, creates more profits for businesses, enabling them to expand. Tax cuts and rebates were used, for example, in 1975 to stimulate the economy, which was then in recession.

Many people are concerned about the mounting federal debt and are calling for a balanced budget as their first concern. Ideally, in times of full employment and inflation, money should be withdrawn from the economy through higher taxes to deflate it and the revenue used for paying off a part of the debt. But most economists believe it is a serious mistake to try and balance the national budget in a period of depression. During a depression, they argue, the government should spend more than it receives, thus putting money into circulation, improving profits for businesses and providing jobs.

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THE CHANGING SIGNIFICANCE OF AGRICULTURE

Ever since Chairman Khrushchev made a pilgrimage to the American farm heartland during the 1950s, the world has been conscious of the miracles wrought by the American agricultural sector. There are several heroic facts as well as several heroic myths about American agriculture. What are some of these facts? Principally they relate to American agriculture's prodigious capacity to produce on the intensive margin, that is, to obtain a large profitable yield per hectare. Modern American agriculture uses a great deal of capital in the form of fixed investment and highly trained labor. Agricultural products are among America's leading exports. But the grain exported in 1980 is vastly different from the grain exported in 1880 (or even at the time of Chairman Khrushchev's visit). The seed has been scientifically developed and redeveloped to be product-plentiful and resistant to disease in a particular climate and during a growing season of a predictable length. There is a calculatedly abundant use of fertilizer and artificially provided water (irrigation). The machinery used in cultivation and harvesting works rapidly with diminishing costs per unit of output. Agricultural labor is increasingly highly trained. It is not unusual to see farmers driving tractors with air-conditioned cabs hitched to very expensive, fast-moving plowing, tilling, and harvesting equipment.

American farms are increasingly agribusinesses; the family-size small farm, so important in the 19th-century development of the American culture and of our political institutions, is no longer economically competitive and is seemingly on its way to extinction.

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However, it is not yet extinct—and reports to the contrary are myths.

Farm employment in 1977, including farm operators and unpaid family workers, numbered more than 4 million, with about 7.8 million of the population (3.6 percent of the total) still living on farms. Almost 40 percent of these farm families had incomes in 1977 of less than $10,000 (well under the national median), with black farmers perceptibly poorer than the white farmers. This condition prevailed at a time when median money income for farm families was $12,637. In 1974 almost 70 percent of the farms were less than 100 hectares; this 70 percent of the farms, however, accounted for only 15.2 percent of the land. Large farms, those over 400 hectares, were 6.7 percent of the total number of farms and accounted for almost three-fifths of the farmland.

For generations, the farming areas were over-represented in state legislatures and in the Congress. As the U.S. Congress, all but one of the state legislatures are bicameral, with members of the upper house (usually called the senate) representing geographical districts without regard to how large or small their population. The rural areas often gave their senators repeated terms in office, thereby permitting them to acquire seniority. As a consequence, legislation was additionally and systematically "biased" in favor of certain kinds of farmer preferences.

Recently, the apportionment of the lower houses has been most carefully studied by judicial authorities and wholesome reforms have been accomplished to restore greater equity between urban and rural areas. For this and for other reasons (the latter largely pertaining to the vast migrations from rural to urban areas), urban centers are now more equitably treated. The agricultural sector is therefore doing less well than formerly. Nonetheless, during this same period, the economic importance of the agricultural sector, particularly in world trade, has, if anything, increased dramatically.

This chapter outlines the evolution of an important aspect of what was once clearly the principal American perception of its role as an agricultural society.

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America began as a nation of small-scale farmers. In 1790, when the first census was conducted, 94 percent of all people in the United States lived in rural areas. These country people produced almost everything they consumed, providing surplus enough to support only one city dweller for every eight farmers. Today only about 3.6 percent of the population is engaged in agriculture.

Early Land Policy

Governing bodies of the American colonies raised questions about land distribution and use soon after winning independence. A 1785 ordinance provided for surveying the West, with the intention of opening up land for family farms. Areas between the Ohio and Mississippi Rivers, for example, were allowed to become states on equal terms with the original thirteen as soon as their populations reached a certain level. The lands were to be sold at $2.50 per hectare.

Most of the settlers who braved the many dangers of western expansion did not have money to pay for land. Often they settled as "squatters" without any clear title to their farms. After becoming established, these settlers campaigned to get the law changed so that some of the land was declared free, while other lands could be bought at a minimal price and paid for over a period of years. Successive laws culminated in the Homestead Act of 1862, giving free land to prospective settlers provided they agreed to "homestead," or live on the land for a period of years. The strategy behind this and subsequent laws was to get land into the hands of family farmers. Land was also given to those who organized the railroads to encourage those costly ventures, and other lands were given to "land grant colleges," which were designed to educate farmers in the newest agricultural and scientific methods. In turn, these groups sometimes sold land to settlers at modest cost. All in all, the legislation did meet its objective of covering the new nation with family farms.

The Impact of Agriculture on Industry

The spread of agriculture during the 19th century played a part in the early industrialization of the United

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States. Although most early agricultural pursuits were related to subsistence farming, or perhaps the trading of commodities within a particular locality, what little industry did develop usually involved sales of agricultural implements and supplies or the processing of agricultural products.

By the mid-19th century, as the Industrial Revolution began to take hold in America, the relationship between agriculture and industry had become more pronounced. As noted earlier, the advance of industry, primarily in the field of transportation, had a profound effect on the ability of the farmer to move his goods to market. Ironically, much of the labor-facilitating industrialization came from the rural areas themselves, in the form of displaced farmers who flocked to the cities to work in the factories and mills. Despite burgeoning industrial activity, the majority of the American people continued to make their living from farming until the early 1900s.

The Beginning of Government Assistance

The westward movement was characterized by periods of good prices for farm products followed by periods of low prices. The farmer who bought or homesteaded his land near the beginning of an upswing was likely to prosper. He could make money on the sale of his crops, and he could often sell his land for a relatively good price. However, the farmer who began near the crest of a cycle was usually in trouble. He faced a succession of years of low prices for his products and often lost his farm.[1] Some of those who lost their farms became tenants, working for someone else; others moved farther west to re-establish themselves on other farms as squatters or homesteaders. Most farmers of the era were basically optimistic, believing in the American ideal that anyone could be successful in his work if he only applied himself and had reasonably good fortune.

By the 1870s, farmers had become more politically astute. They recognized that federal government policies

[1] Homesteads, including the land and buildings, were technically nonalienable, which meant they could not be seized for civil debt settlement; but farm machinery was not exempted.

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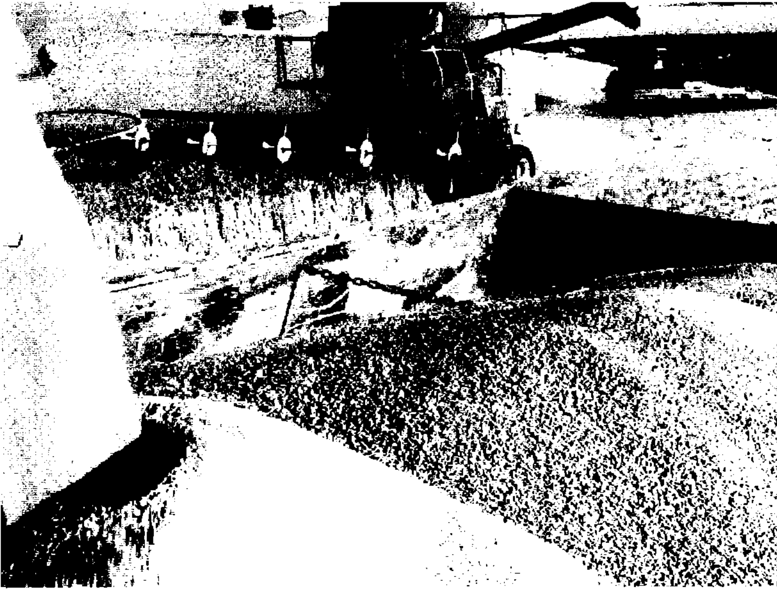

Contributing to farm efficiency, modern combines can perform all harvest functions in one operation; they often work together to cover thousands of hectares in a few hours.

either helped or hindered their livelihoods and began to call out for redress of certain grievances. In particular, farmers began to demand government help in stabilizing prices by slowing down the opening of new lands. In addition, they demanded reforms in the banking system that would benefit them when they needed credit, because the lack of credit was a major problem for both the western and southern farmers of this period. The farmers wanted a policy that would provide "cheap money," or low interest rates, on the money they had to borrow.

Other demands included an improved system of transportation, including particularly regulation of the railroads, which exerted a stranglehold over the farmers' ability to get their products to distant markets. Railroad companies often charged unequal or unfair rates. Farmers also wanted a low tariff on imports, so they could buy consumer goods more cheaply. Perhaps their most controversial demand was for an inflationary currency backed by both silver and gold, instead of by gold alone. The farmers hoped that

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expansion of the currency would lead to higher prices for farm goods.

The farmers' revolt reached its height in 1896, when one of its champions, William Jennings Bryan, received the Democratic Party's nomination for President. On the whole, city dwellers and eastern business interests viewed the farmers' demands with distrust, causing Bryan's defeat at the hands of the Republican candidate, William McKinley. This marked the end of the more radical phase of the farmers' movement, although a number of the reforms they had favored, including regulation of transportation, were eventually enacted at federal and state levels.

Agricultural Specialists

In the period between 1900 and 1930, the United States began to train and encourage agricultural specialists. It would be hard to overestimate the importance of this development because it led to a dramatic increase in output per farmer. States set up "experimental stations," and well-established land-grant colleges and universities trained research specialists in fields related to agriculture. At the federal level, the Department of Agriculture began an intensive program of basic research.

This research helped farmers (as well as the general public) in many ways. For example, new stocks of hogs were imported from the British Isles and Europe and were crossbred to produce hogs that fattened faster on less grain. Soil was tested to determine the kind of fertilizers needed to increase grain production. Other types of experimentation produced dramatic results in hybrid seed, plant nutrition, treatment of plant and animal diseases, and pest control.

The vital role of the railroads in transporting crops to American markets and to ports for shipment overseas is underscored by the fact that, prior to the 1870s, an estimated one-fifth of all farm products spoiled before reaching the consumers. But during that decade railroad cars were refrigerated and heated, providing an enormous boost to the fortunes of farmers.

The concurrent development of industry also helped American farmers because farm youth had other job opportunities if they chose to leave the land. This prevented

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fragmentation of farms into units too small to be economically efficient.

Problems and Challenges of the Twentieth Century

By World War I new lands for homesteading were practically unavailable. Overcultivation and a long period of soil erosion had reduced the fertility of much of the United States's farmland. Forests had been cut or burned to provide additional cropland. Vast regions of grasslands on the Great Plains were depleted by overgrazing. In the mid 1930s a series of dry years resulted in extreme crop losses in the Midwest. The winds of the Great Plains caused huge dust storms on overgrazed lands.

To meet this challenge a philosophy of land use and conservation began to develop. Government bureaus believed farmers needed to be encouraged and educated on the values of better land-use practices. The independent-minded farmers sometimes found it hard to accept that someone else knew their business better than they did, or that they should think in terms of long-range self-interest rather than next year's crop. Government conservation agents were employed to demonstrate better techniques, and when farmers saw that their neighbors who used new methods were prospering, they began to adopt the new methods. Further, government incentives were offered in the form of free service or even cash payment to improve their land.

In the 1920s demand for American farm products fell, as European countries began to recover from World War I and instituted austerity programs to reduce their imports. The result was a sharp drop in farm prices. This period was more disastrous for farmers than earlier times had been, because farmers were no longer self-sufficient. They were paying for machinery, seed, and fertilizer, and they were also buying consumer goods. The prices of the items farmers bought remained constant, while prices they received for their products fell. These developments were made worse by the Great Depression, which began in 1929 and extended throughout the 1930s.

In 1929, under President Herbert Hoover, the Federal Farm Board was organized. It established the principle of

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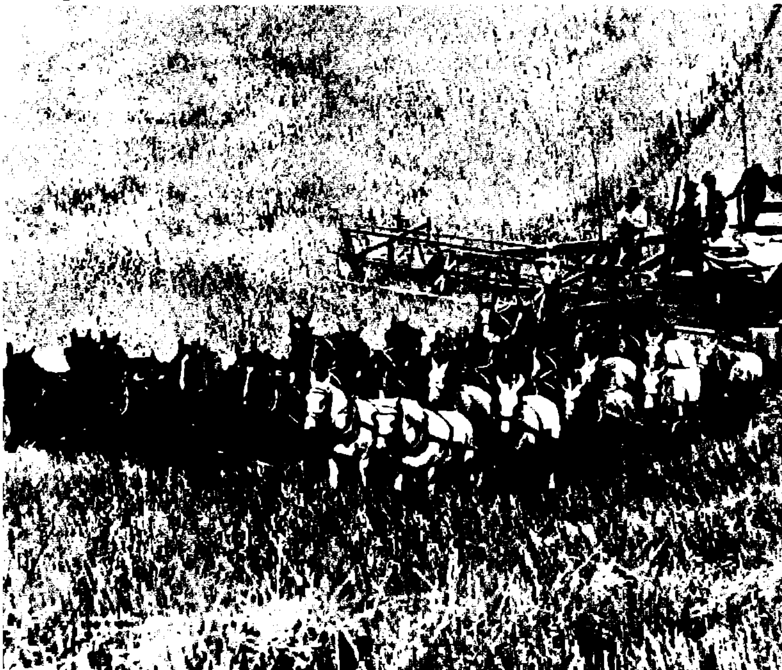
direct interference with supply and demand, and it represented the first national commitment to provide greater economic stability for farmers.

One of the first measures proposed by President Franklin D. Roosevelt when he took office in 1933 was the Agricultural Adjustment Act, which was subsequently enacted by Congress. This law gave the Secretary of Agriculture the power to reduce production through voluntary agreements with farmers who were paid to take their land out of use. A deliberate scarcity of farm products was planned in an effort to raise prices. This law was declared unconstitutional by the Supreme Court on the grounds that general taxes were being levied to pay one special group of people. However, new laws were passed immediately that achieved the same result of resting soil and providing flood-control measures, but which were based on the principle of soil conservation. The Roosevelt Administration believed that rebuilding the nation's soil was in the national interest and was not simply a plan to help farmers at the expense of other citizens. Later the government guaranteed

Harvesting grain in the 19th century required plenty of horsepower and manpower.



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loans to farmers so that they could buy farm machinery, hybrid grain, and fertilizers.

Another Plan for Assisting Farmers

A second plan soon supplanted the idea of paying farmers for not producing food and, indeed, became the cornerstone of national farm policy. Laws were passed to support prices by buying excess grain or animal products, which would otherwise bring a lower price on the open market, at set minimum prices. This base price was called "parity," a ratio between the amount farmers received for products they marketed, such as crops and livestock, and the price farmers paid for commodities they purchased. If market prices for produce farmers sold did not support a standard of living equal to that of the 1910-1914 period, the government agreed to purchase the products at a percentage of parity, the price necessary to maintain that economic standard.

For more than 30 years a debate has raged over the wisdom of parity support. Many people opposed such support because of the high cost. Another problem was that storage bins were bursting; abandoned ships from World War II were filled with grain by the 1950s, and other grain was piled on the ground where it quickly rotted. Some argued that the cost of farming had actually gone down because of better seed, fertilizer, and equipment, so it was not necessary for farmers to receive the same relative prices that they had had during historic base periods like 1910-14. Finally, some argued that subsidizing farmers rewarded inefficiency, simply postponing the day when less productive farmers would have to find other work.

Other measures were designed to help farm families in the United States. In 1935 Congress established the Rural Electrification Administration (REA), which extended electric power lines into the countryside. Local cooperatives were established, and the federal government provided credit for them to build rural power lines. Farmers soon found that electricity enabled them to make great technological advances. By 1960, 97 percent of all farms had electricity. Other assistance to farmers was a network of "farm-to-market roads" that made towns and cities easily accessible to rural areas.

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The Second Agricultural Revolution

The extensive changes that have occurred in farming since the end of World War II constitute what has been called "the second agricultural revolution." This period has seen the decline of the family farm and increase of mechanization. A century ago one-half of the labor force worked on farms; today that figure is down to less than 4 percent. Commercial farmers have become increasingly specialized so that, for example, a farm family may buy milk at a grocery store rather than keep a single cow. Almost everything consumed on most farms is now bought rather than grown. In general, machinery has replaced hired labor.

By the 1950s farmers felt they had only two choices—expand or get out of farming. Some farmers purchased their neighbors' land. In other places, outside interests bought entire areas for large-scale corporate farming. In 1940 there were six million farms averaging 67 hectares each; in 1978 the situation had shifted to the point where there were only 2.7 million farms averaging 160 hectares each. This trend toward large-scale farming has driven many largely untrained rural people into the cities, where because of their lack of specialized skills they have often lived in poverty.

The high cost of capital investment in land and equipment makes entry into farming very difficult for most individuals. Some experts predict, therefore, that even family farms will have to incorporate. Experts have noted that such a development would be a real detriment to the American way of life, because farm families have set a standard of hard work and stability and have seemed to enjoy their way of life.

This observation has influenced much of American farm policy. For example, there is a law limiting the amount of hectares one may own to qualify for the use of federally irrigated water, although many argue that this provision is both outdated and not rigorously enforced. Still others point out that there is no single answer to the controversy between large-scale and family farming, noting that it really depends on the kind of farming one is engaged in and the kind of crop being raised.

Despite these controversial aspects of the second agri-

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cultural revolution, it is clear that there has been an unprecedented increase in the capacity of the American farmer to produce. First, there was a vast increase in the productivity of labor. This was brought about by new technology, mostly in the form of such heavy machinery as the reaper, the combine, and the harvester.

Second, there was an astonishing increase in the productivity of the land. The advent of scientific farming methods and better technical support has led to the so-called "yield explosion" and made a major contribution to increasing the world food supply. The government has supported this process through grants and the funding of agricultural universities. In recent years the government has become more vigilant about regulating some of the chemicals used in pesticides and fertilizers, after public interest groups demonstrated they were harmful to plants and animals, including humans.

Distribution of Surplus Agricultural Commodities

From the 1920s until the 1970s America's agricultural problem was overabundance. The nation steadily gained the capacity to produce more than the population could consume, and more than the nation could profitably sell abroad.

Two types of programs evolved to help use surplus food products, one dealing with international distribution and the other relating to feeding hungry people in the United States. In 1954, Congress passed Public Law 480, called the "Food For Peace" law. United States exports of food and fiber had helped promote the recovery of Europe and Japan, so President Harry S Truman reasoned that such shipments would be effective in promoting the economic growth of the less developed countries.

Farmers saw the Food For Peace program as a way to reduce the national surplus, which was a price depressant. Economy-minded city dwellers saw it as a way to cut the public cost of storing surplus grain. Finally, humanitarians saw it as a means of helping to feed the hungry of the world. A total of $25,000 million worth of food and other agricultural products has been sent overseas under this program. Much of the food was used as incentive payment in

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developing countries, where workers in local development projects were paid with American foodstuffs.

The success of the United States in food production is viewed by some as an integral part of the overall world effort to feed its population in the future. For many years American surplus grain has helped to constitute a 100-day world supply of food reserve. Considering the increasing world population, it is reasonable to expect a continuing relationship between American agriculture and the rest of the world.

Surplus food was also used to feed undernourished people in the United States. An early popular program provided free school lunches, using such commodities as surplus milk, butter, eggs, and bread. More recently, the Food Stamp program has grown rapidly. A person with low income is declared eligible to buy food stamps, which are accepted by grocery stores as payment for certain basic food and household staples. The stamps cost the eligible recipient far less than the value of the items. Most people see this as an improvement on the previous policy of distributing to the poor only those foods that were declared to be surplus. The Food Stamp program has been used as one part of a welfare system for the poor that includes the payment of income supplements to those below a certain "poverty" income level. In recent years, however, some social scientists have recommended phasing out such "aid-in-kind" programs as the Food Stamp system in favor of a more generalized system of income supplements.

Outlook for the Future

The agenda for the future would seem to include the development of a coherent farm policy that deals adequately with the unstable conditions of the marketplace. Farming has been an up-and-down industry. America began as a nation of farmers; the cheap land of the frontier offered almost unlimited opportunity. But today wheat, corn, pork, beef, and other products are sold in a highly competitive market with prices changing daily.

The farmer (often with government assistance) has attempted to exert a measure of control over market fluctuations. During times of surplus, with resultant lower prices, farmers tend to cut back on production in the hope

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that prices will rise. In recent years, consumers, already hit hard by an inflationary spiral, have become increasingly critical of efforts to raise food prices through manipulation of supply. In addition, with uncertain prospects of future world food supplies, it distresses some Americans to see the government paying farmers not to produce.

Farmers, on the other hand, believe they cannot be expected to overproduce if doing so undermines the price they receive for their products. The government's response has been to develop a system of price supports as a possible alternative to the practice of paying farmers to set aside land from cultivation (or otherwise limiting production of their goods). Under the price support system, the government maintains a higher price for specific crops, such as wheat or corn, than consumers normally would be willing to pay. The government then agrees to buy whatever surplus the farmers are unable to sell at the artificially high price.

In recent years, economists have supported an alternative system of direct payments to farmers. Under this plan, the government sets a base price and pays the difference if farmers receive less in the marketplace.

Lawmakers and officials concerned with agricultural policy are seeking new ways to reconcile farmers' needs with those of others in the United States and, indeed, the world. Although agriculture no longer holds a dominant role in the American economy, it clearly must be considered an important national asset.

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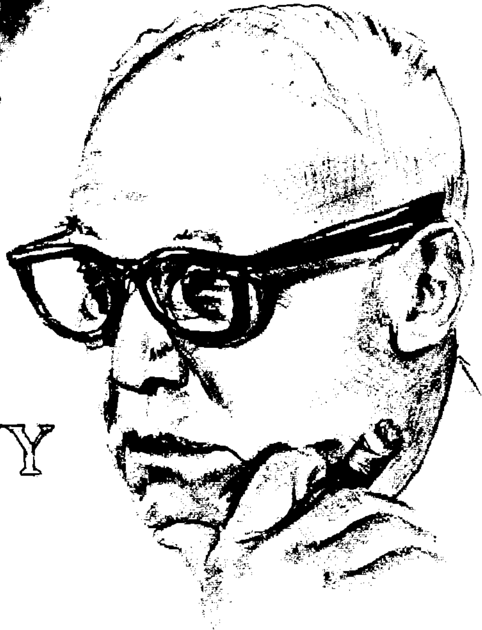
LEWIS

GOMPERS



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LABOR'S CONTRIBUTION

It may come as a surprise to many, but the American trade union movement is the world's oldest. There have been unions in the United States since the end of the 18th century. Why should America, such a new nation, have such an old movement? When one thinks about it, the answers are almost obvious. Labor was in short supply and was able to use its scarcity as a basis for relatively successful bargaining. Moreover, manhood suffrage had been accepted generally in the United States by the early years of the 19th century; and this voting power that European labor movements were struggling to get, American workers had already achieved. Finally, there was virtually no history of feudalism in the United States, and working men had an ingrained self-perception of equal citizenship. The earliest labor unions in the United States had very specific goals; besides improving wages, hours, and working conditions, they sought to get free elementary school education, preference in employers' bankruptcy proceedings, and relative freedom from paying taxes in lieu of civil guard service.

The philosophy of the American labor movement puts great emphasis on the workers' collective ownership of job opportunity, something they consider to be a logical extension of traditional property rights, itself a most conservative doctrine. The American Federation of Labor, originally founded in the 1880s, was the nation's dominant labor organization until it merged with the Congress of Industrial Organizations (CIO) in 1955. It had only three major leaders through its 75-year existence. The tone of the organization was originally set by Samuel Gompers, president from 1881 (except for one year) until his death in 1924. The second

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president, William Green, served from 1924 until 1952. The third president, the late George Meany, served from 1952 until 1955, when he became head of the merged AFL and CIO, a position he held until 1979. These three men were the despair of socialist reformers. Each stressed the essentially pragmatic nature of the American labor movement. They sought, generally successfully, to enhance the real living standards, not just the political power, of American workers.

This peculiar philosophy of the American labor movement, called by one of its historians "job consciousness," has served to make the American labor movement stand apart from labor movements of most other countries, Canada excluded. Because there has been no national American labor party, there is a myth that the American labor movement has eschewed political action. However, at state and local levels the labor movement has always been very active on the political front, taking care to "reward friends and punish enemies" and at the same time to secure the benefits of protective legislation as well as favors due to the backers of successful candidates. On the national level, the American labor movement was traditionally quite careful about revealing its hand. It tacitly supported Woodrow Wilson during his terms of office (during 1913-1921), but overtly supported Franklin Roosevelt (1933-1945) and Harry Truman (1945-1953). But by the early 1950s, the American labor movement was clearly deeply involved in the internal politics of the Democratic Party. At times it has gotten enthusiastic cooperation from the party's leadership; at other times it has not fared so well.

In the early days of the movement, American trade unions were disturbed by the effects of the widespread immigration of workers willing to accept substandard wages. But in recent years, the movement has been cooperative with regards to immigration of foreign workers into the United States. Why? Because the leaders of the movement, and a great number of its members, have been very conscious that they, themselves, were immigrants or that they were sons and, at most, grandsons of immigrants. Thus, although no typical American union member has urged the "work-

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ers of the world to unite," the fact is that the movement has been quite willing to extend the opportunity it has enjoyed to vast numbers of immigrants. All of the foregoing has been accomplished with virtually no sense of working-class consciousness.

Since Franklin Roosevelt's administration, the United States has been a land with a relative tolerance for workers' organizations. It was not always so. Prior to 1933 unionism, except for wartime periods, faced strong and rather imaginative, employer opposition. In the 1920s, the personnel administration movement, scientific management, and the generosity of rising real wages combined to offer American workers what was advertised as an efficient alternative to unionism. The Great Depression of 1929-1940 was the watershed. Thereafter, unionism seems to have come to stay.

The power of union leadership is both great and small. It is great in the sense that union leaders can, particularly when corrupted, favor one firm over another or one industry over another. It is small, however, when one realizes that the unions are quite open, particularly on the local and state levels, and with open elections there is always the possibility that some relatively obscure figure can, by promising more aggressive pursuit of wage and other job benefits, secure the office for himself and his group.

The labor movement contributes to the American economy by representing the interests and needs of workers to management and government. Although only about 30 percent of all American workers in jobs that lend themselves to union organization are members of a union, most of the nation's important industries—steel, mining, automobiles, and the like—have been organized by unions. Economists have disagreed on whether or not unions have significantly affected workers' wages—most pointing to increased productivity as the major factor in rising salaries. However, one thing most analysts can agree on is that unions exert influence disproportionate to their size, representing workers' interests in job safety, procedures for

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handling grievances, and monitoring other working conditions. The average worker can derive considerable satisfaction from the fact that, through a union, he or she has a voice about all aspects of the job. In addition, some experts would argue that unions have performed a valuable social function, serving as a fraternal organization, and perhaps more importantly, as a source of pride to workers long denied a sense of dignity and power.

Brief History of the American Labor Movement

The labor movement did not develop quickly or smoothly in the United States. As late as 1839, only 17 percent of the work force was engaged in manufacturing. By 1859, this number had grown to 32 percent, a significant increase; yet the United States was still primarily an agricultural nation. It was not until the latter decades of the 19th century that America really began to take on the industrial character that today we take for granted.

Unskilled workers fared rather poorly in the early life of the new nation. About 40 percent of the working class in the cities was composed of laborers and seamstresses in clothing factories. This group received low wages and often lived in dismal circumstances. Skilled workers, such as craftsmen, artisans, and mechanics, received up to double the pay of the unskilled. They tended to own their own homes and were considered solid citizens of their communities. As early as the 1830s, carpenters, printers, shoemakers, and others had begun to organize themselves into journeymen's societies and benevolent associations. Though they did not consider themselves unionized, they did act in concert. They demanded a minimum wage and shorter working hours; working days usually ran from dawn to dusk, summer and winter, which meant summer working days were much longer.

With the rise of factories came significant changes in the work force. The use of child labor, women, and poor immigrants at the machines became commonplace. In New England in the 1820s and 1830s children under age 16 constituted one-third to one-half of the labor force in some factories, especially in textiles. It is interesting to note that 5 percent of the entire slave population worked in factories

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by 1850. About four-fifths of them were owned outright by those using their labor, and the rest were rented by the month or year to factory owners by their masters.

Industrial growth also brought other changes. Innovations in technology and business practice led to specialization of function for both labor and management. This, coupled with the growing number of workers being employed, caused many workers to feel they had no voice in their economic destinies. They felt cut off from their work and described themselves as cogs in the industrial machines. Some turned to unions to improve their situations.

The first significant national labor movement was called the Knights of Labor. Founded in 1869 after the Civil War, it began in Philadelphia among the garment cutters. The Knights were a class-oriented movement, dedicated to organize all workers for the general betterment of their lot in life. Considerable idealism surrounded the movement.

At first the Knights of Labor was a secret society. It was broad-based, welcoming even blacks and women. It excluded "only lawyers, bankers, gamblers, and stockholders." By 1886, its high point of interest and power, the union claimed some 700,000 members. They were a mixed group of skilled craftsmen and unskilled factory workers in a given industry—in short, anyone who wanted to join.

The interests of these various groups were often in open conflict with each other. As a result, members had very little identity with the movement, and there was poor organization. More interested in human dignity and idealism than with the practical matters of wages and working conditions, the Knights of Labor nonetheless attempted a number of strikes. After some initial successes, they failed badly in a strike against the railroad tycoon Jay Gould in 1886. Their loosely constructed organization began to fall apart and membership declined sharply in the late 1880s.

Rise of the American Federation of Labor

In 1881 the predecessor of the American Federation of Labor (AFL) had its beginning. Unlike the Knights of Labor, the AFL was organized on the basis of specific

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craft unions, not workers as a whole. Because of this, most unskilled workers were excluded from the movement. Six prominent craft unions—the iron workers, molders, printers, cigar makers, carpenters, and glass workers—established a loose federation. This marked the currently relevant beginning of a sustained labor movement in America. Best known of the leaders was Samuel Gompers of the cigar makers. The initial membership was only 45,000. In 1886, when the Knights of Labor refused to recognize their right to represent the larger craft unions, members of the federation withdrew and officially founded the AFL.

Gompers's three-point program of union strategy has served the AFL movement throughout its history. First, he insisted on working for practical benefits in the form of higher wages and better working conditions, rather than engaging in a philosophical class struggle. Second, he committed the AFL to the principle of federalism within the movement, allowing each union considerable internal freedom to organize and operate according to its own style. Third, he did what he could to keep government out of collective bargaining, while favoring rewards to political friends and defeat of members of Congress who opposed labor's position. Gompers also insisted that no more than one union should try to organize the same workers at the same time. The philosophy of the AFL dominates the direction of the entire American labor movement.

Despite the successful beginning of the AFL, labor organizers faced a number of difficulties. For the most part, employers had never fully accepted the legitimacy of unions, much less their right to strike or bargain collectively. Management, which preferred to discuss issues separately with each worker, often sought to circumvent the union, firing or "blacklisting" (agreeing with other companies not to hire) those workers who were favorable to unions, or by signing their workers to "yellow dog" contracts, which prohibited them from joining unions.

Employers also sought court injunctions against unions to stop them from engaging in strikes. They did this because during most of the period 1880-1932, the government and the courts were generally sympathetic to the position of management, or at best neutral. In fact, it was often the government, in the name of public order, that

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Samuel Gompers (center), first president of the American Federation of Labor (AFL) and a revered leader of the labor movement, laid the cornerstone of the AFL building in Washington, D.C., in 1915.

provided the force necessary to put down a strike, as occurred in 1894 when President Grover Cleveland ordered federal troops to end a strike by railroad workers against the Pullman Palace Car Company. The organization of labor was not without its bloody moments.

By the close of World War I, the AFL had some five million members and was not only growing numerically but also in influence. It was composed of craft unions and appealed to skilled workers. However, growth slowed during the 1920s when labor met determined opposition from business groups like the National Association of Manufacturers (NAM). One fierce battle was over the principle of the "open shop," the right of a worker not to be forced to join a union. In general, the 1920s were prosperous years with high employment, so that workers felt relatively secure without union support. After the death of Gompers in 1924, William Green was elected President of the AFL as a compromise candidate.

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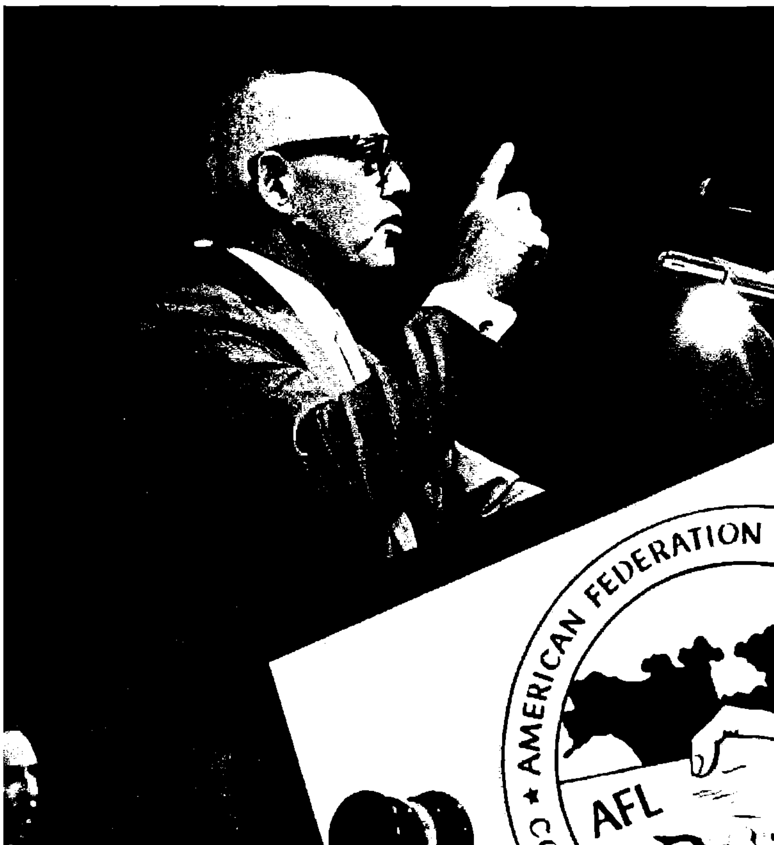
Formation of the CIO

The advent of the Great Depression reduced AFL membership to fewer than three million, but the depression had one positive value for the labor movement by creating sympathy for the plight of working people. With the election of Franklin Roosevelt, government and the courts be-



The late AFL-CIO President George Meany was a dominant—and in domitable—leader who exercised far-reaching influence.

gan to look more favorably on the pleas of labor.

The structure of the AFL stood in the way of organizing the great mass of unskilled factory workers. In 1935 John L. Lewis, president of the United Mine Workers, Sidney Hillman of the Amalgamated Clothing Workers, and other leaders formed the organization that was to be-

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come the Congress of Industrial Organizations (CIO). John L. Lewis was named president. Helped by a favorable attitude in Congress, a whirlwind campaign was launched to organize great industries such as steel, automobiles, oil, and rubber—over the bitter opposition of the managements of these corporations. The CIO developed rapidly and grew into a full competitor with the AFL.

The Wagner Act of 1935

The changing attitude of Congress toward labor unions led to passage of a series of pro-labor bills, the most important of which was the National Labor Relations Act of 1935. Better known as the Wagner Act, this historic bill stated:

> **Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in connected activities for the purpose of collective bargaining or other mutual aid or protection.**

For the first time, labor had been given the express right to bargain collectively. Moreover, the act established the National Labor Relations Board (NLRB) to make sure employers did not engage in "unfair labor practices." The NLRB was required to go into factories and hold elections when workers wanted to organize or to be represented by a particular union. It gained the authority to force employers to provide back pay if employees were unjustly discharged because of union activities. Without such support from Congress, the unions could never have grown to their present strength. Given this legal stimulus, trade union membership jumped to almost nine million by 1940.

Anti-Union Trends

After World War II there was a sharp reaction among many people, spurred by industry, against what they considered the unwarranted power of unions. Labor was depicted as having more power than industry. Many people believed the Wagner Act had been one-sided in favor of labor. As a result, in 1947 Congress passed the Labor-

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Management Relations Act, better known as the Taft-Hartley Act. Named after its sponsors in the Senate and House of Representatives respectively, this two-edged sword, which was passed despite the bitter opposition of labor, prescribed standards of conduct for unions as well as for employers. Workers not wanting to join unions were protected. (Unions felt this was unfair because they believed non-union workers enjoyed benefits gained by the union without sharing in the costs.) Strikes imperiling the national health or safety could be suspended for 90 days upon the request of the Attorney General. Unions were required to give 60 days' notice before calling a strike. Unions could be sued and held responsible for the acts of their agents. Political activities and financial contributions to elections were restricted for labor unions. Despite continued efforts by its critics to repeal this act, it is still in effect.

Labor's Power Today

Labor has come a long way since its organizational struggles. Oldtimers at union conventions recount the days when management brought in "scab" workers (replacements for union members) and even thugs to threaten workers and force them back to their jobs. They remember the victories that established the principle of collective bargaining, culminating in the laws of 1935 that won the unqualified right of workers to organize without interference from employers.

In 1955 the AFL and the CIO merged to represent an organized voice before Congress and a strong united stand against industry. This merger made the AFL-CIO the nation's largest labor organization. George Meany, who had been president of the AFL from the time of William Green's death in 1952, assumed the presidency of the AFL-CIO. Walter Reuther, former president of the CIO and head of the huge United Automobile Workers union, soon felt restive under the dominant leadership of George Meany and split his union from the AFL-CIO.

By 1976 some 21 million union members enjoyed the benefits of a highly developed system of collective bargaining. One in every five workers in America belonged to a labor union. Millions more who are not organized enjoy some of the benefits won for them by those belonging to

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unions. Under the law, labor representatives enjoy equal status with representatives of management and ownership.

When workers in a given factory or industry want to organize, they follow this process: The workers ask the organizing union to petition the NLRB for an election to determine the exclusive bargaining agent in the plant. The NLRB sponsors an election on a day that has been an-

In 1958 Walter Reuther (right), head of the United Automobile Workers Union, sealed agreement on a three-year pact with the Ford Motor Company by shaking hands with John S. Bugas, Ford vice-president for industrial relations, following extensive bargaining.

nounced well in advance. If a majority of the workers votes in favor of a union, the NLRB then certifies it as the official bargaining agent for the factory, thus preventing any other union from negotiating directly with management. A day is set for the new union representatives, chosen by the workers, to meet with representatives of management. They begin to negotiate a whole series of issues

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including, but not limited to, wages and hours, pensions and health insurance, seniority rights of workers, and grievance procedures. They may negotiate for a "union shop" requiring all employees to become union members within 30 days after the beginning of their employment. In the end a contract is signed by both sides. Everything is set down on paper so that all know the exact agreement. Both parties often agree to arbitration should disputes arise that cannot be resolved. In such cases, each side agrees in advance to accept the decision of an impartial outside arbitrator. Contracts are usually negotiated for a one- or two-year term.

Current Issues and Problems

A major point of criticism of the labor movement is its demand for ever higher wages and better working conditions even during periods of inflation. Opponents claim that contracts often add to inflationary fires. Labor counters that most recent increases in wages are designed just to keep up with the cost of living, not to make substantial gains in real standards. Labor has continued its fight for higher wages and has succeeded in including new groups of workers, such as government and service employees, in its unions. By June 1979 the average hourly wage paid to U.S. factory workers was $6.65.

In addition to disagreements over wages, the struggle between labor and management has increasingly focused upon what special benefits to which the respective parties believe workers are entitled. Issues related to retirement benefits, disability pay, and medical insurance, as well as recent demands by some very large unions, including the steel workers, for lifetime job security, are hashed out between the two sides.

For their part, employers have not seen fit to sit back and let labor have its own way. Management wants increased productivity from its workers and has shown a willingness to counterattack against rules or benefits it believes are detrimental to this end.

Another labor-related problem of society is the effect of automation on employment. Because of the trend toward machines replacing persons, traditional blue collar jobs are disappearing, and more workers are moving into personal and social service employment. Jobs in such

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fields as education, health care, and entertainment have expanded. Federal job-training programs have been created to prepare workers for new kinds of jobs. On occasion, unions have been accused of "featherbedding," requiring more workers than are necessary to do a task.

In a dynamic and changing world, actions such as featherbedding are at least understandable. Fears on the part of both management and labor that soon there may not be enough jobs to go around goes a long way toward explaining the popularity of such ideas as the four-day work week, shortening of the work day, and longer periods of vacation. Some analysts argue that the best way to create new jobs is for government to offer incentives to business to increase capital investment. Still others argue that investment incentives would simply be a windfall for business without benefitting workers. Whatever the answer, labor is certain to participate in the national dialogue.

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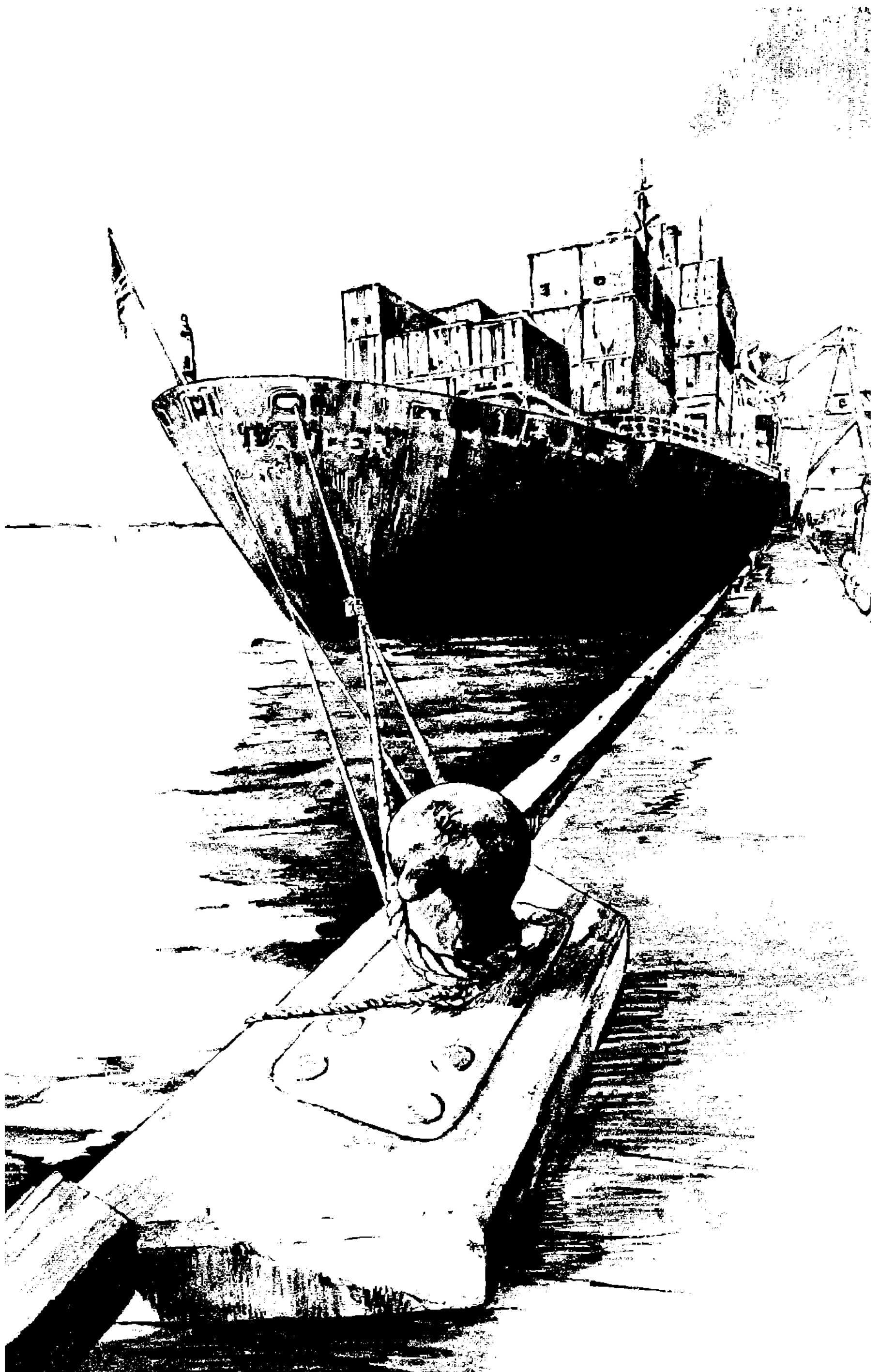

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FOREIGN TRADE AND ECONOMIC POLICY

Much of the foregoing discussion was basically predicated on the traditional American preoccupation with the development of its own economy, irrespective of what went on abroad. In truth, America has always had a strong dependence on foreign capital markets either, as in the original decades, because the United States was a borrower; or, as has been the case particularly since World War I, because the United States was a major lender. But, like many young people, young nations are preoccupied with their own feelings, their own experiences, and their own problems. They are relatively oblivious to their impact on other nations' feelings, other nations' experiences, and, of course, other nations' problems.

At the beginning of the Republic, Alexander Hamilton advocated a protective tariff as a way to encourage American industrial development. By and large his advice was adopted. And although there were various tariff acts passed between the first act (1791) and the present, the general rule was for tariffs to grow in their "bite" and in their importance to economic changes until the Great Depression. The most protective of American tariffs was the Smoot-Hawley Tariff of 1930. In the 1930s politics began catching up with economics (or perhaps it was the other way around), and the United States abandoned its high protection posture. World War II caused the United States to become not only the banker but also the lender for most nations of the non-Axis world. And when that war ended in 1945, the United States was prepared to play a most atypical (from the standpoint of its own history) role. In the ensuing years American policy was directed at restor-

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ing the economic capacity of a great many nations. This development did not occur in a vacuum; after the war, not peace but a cold war ensued. The United States sought to coordinate its economic generosity with "the other side," but the Soviet-led nations would have none of it.

International economic policy became by 1947 part of international political policy. And for the better part of 28 years the United States provided not only the capital finance but also the political leadership of the Atlantic community (including Greece, Turkey, and Japan). The institutions created at the end of World War II for the purposes of world development, namely the International Bank, Bank for Reconstruction and Development (World Bank), the International Monetary Fund, and the United Nations, enjoyed such success as they did largely because the United States was willing to bear very large portions of the total cost.

But as time went on, the United States became increasingly disillusioned with the role it was playing, became somewhat exhausted economically and politically by the strains put on it by its post-World War II role, and became increasingly involved with its own domestic political stability. This involvement led to very heavy investment in solving economic problems of the historically disadvantaged groups in the American society.

The continual drain of the cost of these policies was becoming apparent by the early 1970s when in 1973 the major oil-exporting nations formed a cartel to increase the price of petroleum. The price rose rapidly fourfold. Indeed, it has subsequently risen even more, with no end in sight.

The relative power of the United States to shape events seems to have greatly diminished. Nonetheless, it remains a major trading nation in the world's international economy.

It is usual to note that there are great advantages to international specialization in the production process. But most Americans now believe that the advantages of such specialization require some critical understanding of the costs of this policy. Many poor nations, particularly those which are underdeveloped economically, do not believe that this great colossus, the eco-

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nomic leviathan, really can suffer economic pains. Other industrialized nations, perhaps somewhat tired of playing "second fiddle" in the world's economic orchestra, have decided to challenge the United States for the principal role.

We are living in a period of flux, a period of new evaluations, a period of changing and emerging policies. This chapter sets the agenda for the future by describing what past beliefs have been as well as what past policies have produced.

Every day most Americans buy goods imported from abroad, and people all over the world eat food or use products obtained from the United States. Thanks to trade among nations, people in all countries enjoy higher standards of living than they would otherwise.

International trade sets in motion a worldwide division of labor and resources. Each nation, in theory at least, can specialize in production of the goods and services for which it is best suited and can buy abroad those things that can be produced best elsewhere.

Principles of American International Economic Policy

Historically the United States has had a strong drive toward economic protectionism—the practice of using tariffs or quotas to limit imports of foreign goods in the interest of protecting native industry. This policy originated early in the nation's history. It was possible because of geographic isolation; it was necessary because new industry needed to grow to a size that would permit some economies of scale, and meeting competition from abroad would not allow it to grow.

Before the 1930s the U.S. government had little sustained involvement in international economic policy. The famous Smoot-Hawley Tariff of 1930 had capped the protectionist tradition. But since that time, American policy has moved steadily toward a shared global perspective, although until recently the United States usually ignored the world in setting its own *domestic* economic policy. The

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nation felt free to do this because its resources, market size, and technology all helped create a high degree of self-sufficiency—or, as economists put it, autarchy.

During the 1960s and 1970s, the United States leaned heavily in the direction of freer trade. At least four arguments have been advanced for this policy: (1) Without international trade the United States would have to do without products such as tea, coffee, or bananas; the country's use of metals such as steel, aluminum and uranium would be reduced; and consumption of petroleum would be cut in half. (2) Some goods can be obtained more cheaply from other parts of the world where labor costs less or where natural conditions make them less expensive to produce. American consumers should be permitted to benefit from these lower prices. (3) The nation gets better quality products through free trade because some countries specialize in making particular products with quality and skill. (4) The nation cannot enjoy the prosperity that comes from selling its products abroad unless it accepts imports from countries to whom it sells. The United States exports products such as aircraft, computers, and machinery, along with farm products such as cereal grains and cotton. Each year in the mid-1970s, for example, the country exported about 40 percent of its cotton crop.

Even now, the United States has not committed itself to free trade in the classical sense of the term. Instead, America's official policy has been to apply certain principles to trade agreements. First is the policy of nondiscrimination. According to this principle, nations must not charge a higher duty on products they import from the United States than is charged to other nations on similar imports. Conversely, the United States will avoid discriminating among the nations from which it imports goods, charging the same tariff rate to all countries. A second policy is reciprocity, which says in effect that one nation has to make no greater internal adjustment than the other in the implementation of trade agreements. Third, the United States has followed a plan of multilateral tariff reductions, as outlined in the Trade Expansion Act of 1962. This act authorized the so-called "Kennedy Round" trade negotiations, aimed at reducing tariffs between the United States and its major trading partners.

Despite such efforts to eliminate barriers to free trade,

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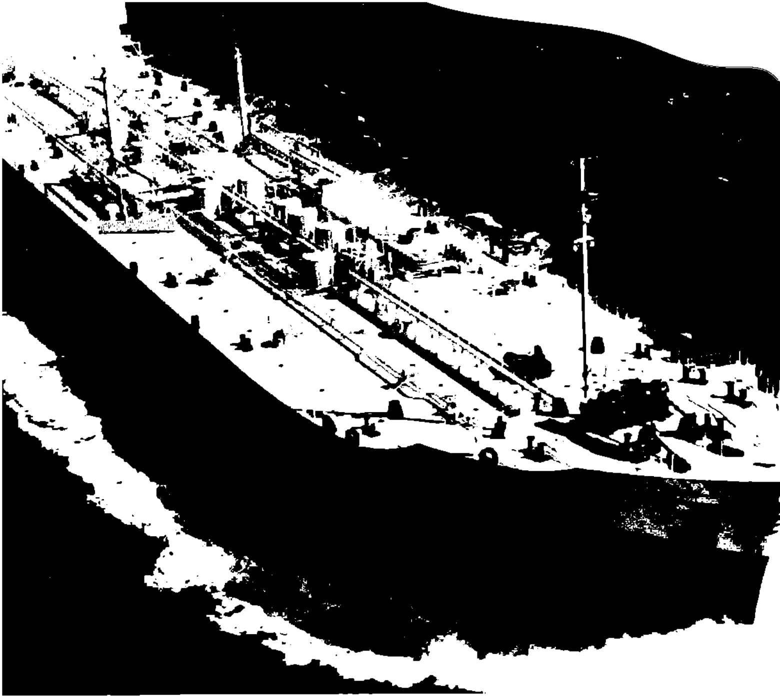

The cargo tanker Valley Forge is one of the many vessels engaged in plying foreign trade; it can transport 36,000 dead-weight tons of oil.

the United States has felt it necessary, for reasons of foreign policy, to discriminate in trade against several clearly ''unfriendly'' countries. Recently some American foreign policy experts have questioned this approach.

The Level of International Trade

Exports have always played an important part in several sectors of American economic life, particularly agriculture. Imports have played a relatively smaller role. The proportion of imports to Gross National Product (GNP) was 7 percent until the turn of the century. Around 1900 it fell to 3 percent and remained near there for nearly 70 years. During the next decade, particularly after 1973, the situation changed drastically. By 1973 imports had grown

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to more than 7 percent, and by mid-1980 they were above 10 percent.

The chart below indicates the growing amount and percentage of imports in relation to a rapidly expanding Gross National Product.

GROSS NATIONAL PRODUCT:
EXPORTS, IMPORTS
(Billions)

Year	GNP	Exports	Imports	Percentage of Import to GNP
1933	55.6	2.4	2.0	3.6
1943	191.6	19.1	8.1	4.2
1953	364.6	17.1	16.5	4.5
1963	590.5	32.6	26.6	4.5
1973	1,303.6	101.6	94.4	7.2
1978	2,106.9	204.8	216.8	10.3
1979	2,368.8	257.5	262.1	11.1
1980 (2nd quarter)	2,521.3	307.0	309.2	12.3

Source: Department of Commerce, Bureau of Economic Analysis

U.S. investments abroad were not critical until recent years. In 1914, an old dateline for data in this field, the U.S. private long-term (direct) investment abroad stood at $3.5 thousand million. In 1930 the figure had risen to $15.2 thousand million. But it dropped during the 1930s. By 1946 it rose again to $12.3 thousand million. The decade from 1946 to 1955 saw a doubling of long-term foreign investment. Direct investment is now growing rapidly, so that by the end of 1978 it reached $168.1 thousand million.

It was not until the early 1970s that the income derived from investments abroad began to exceed the annual investment outflow. In 1974 income was $18 thousand million compared to a $4.5 thousand million dollar outflow, according to The International Economic Report of the President, March 1975.

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For more than a decade, leaders of many nations have been alarmed because they believe American business interests could dominate the economies of their countries. For example, American business controlled 45 percent of all manufacturing in Canada by 1967. As a result, Canada passed laws curtailing further American takeovers of Canadian companies and founded the Canadian Development Corporation which is authorized to buy American and other foreign companies that operate in Canada.

More recently there have been comparable complaints from some Americans who have become alarmed by the level of investments in the United States by Western Europeans, Japanese, and companies and individuals from oil-rich nations.

The table below indicates the amount of import and export of merchandise between 1970 and 1979. Obviously, international trade is growing rapidly and the United States is becoming intertwined with the world economy at an accelerating rate.

U.S. MERCHANDISE EXPORTS AND IMPORTS BY AREA, 1970-79 (Millions of Dollars)

EXPORTS AREA	1970	1973	1976	1977	1978	1979
Canada	9,079	15,104	24,106	25,788	28,374	33,096
Western Europe	14,463	21,360	32,346	34,760	39,929	54,331
Japan	4,642	8,313	10,145	10,529	12,885	17,579
Developing Countries (Including petroleum exporting countries)	12,993	20,963	40,364	43,307	52,895	62,982
IMPORTS						
Canada	11,092	17,715	26,237	29,599	33,525	38,099
Western Europe	11,070	19,114	22,398	27,669	36,483	41,684
Japan	5,875	9,676	15,628	18,550	24,458	26,243
Developing Countries (Including petroleum exporting countries)	10,442	20,312	52,628	67,703	71,230	92,345

Source: Department of Commerce, Bureau of International Economic Policy and Research.

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U.S. government policy may encourage private investment in developing nations—for example, this Goodyear plant near New Delhi where some 800 Indians produce 1,200 tires a day.

Development Assistance

Large-scale American involvement in the world economy may well be traced back to the United States' decision to help Europe undertake recovery after World War II. Although assistance to nations with grave economic problems evolved slowly, the American people felt a sense of satisfaction when the Marshall Plan proved successful as a catalyst to European recovery from the war. President Truman decided to build on this success by helping developing nations grow along Western democratic lines. Others supported such aid for purely humanitarian reasons. Some foreign policy experts, worried about a "dollar

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shortage'' in the war-ravaged and underdeveloped countries, believed that as nations grew stronger they would be willing and able to participate equitably in the international product markets.

This assistance began with Greek-Turkish Aid, the Point Four Program, and ultimately the Marshall Plan. Harry Truman, in his 1949 inaugural address, set forth an outline of this program, and seemed to stir the nation's imagination when he proclaimed it a major part of American foreign policy.

The program was reorganized in 1961 and is now administered through the Agency for International Development (AID), technically a branch of the State Department.

AID programs in recent years have moved away from grand development schemes such as building huge dams, highway systems, or basic industries. Now the emphasis is on (1) food and nutrition, (2) population planning and health, (3) education and human resources, (4) specific economic development problems, (5) famine and disaster relief assistance, and (6) Food For Peace, a program that sells food and fiber on favorable credit terms in the amount of $1 thousand million annually and makes outright gifts to the poorest nations in the amount of $800 million annually.

AID has multipurpose missions that provide major assistance in 33 nations, programs with moderate or declining assistance in 12 countries, and small programs in nine other countries.

The American Dollar and the World Economy

It is perhaps ironic that American aid programs have contributed to one of the more difficult problems facing the United States—a large balance-of-payments deficit and consequent depreciation of the dollar's value. During the 1950s and early 1960s America had a modest trade deficit. This was seen as desirable by most monetary experts in the United States because it meant that more dollars were available to other countries. The world, in effect, used dollars rather than gold as the basic medium of exchange.

However, in the late 1960s, during the Viet Nam war, United States deficits increased too rapidly. Heavy purchases of relatively inexpensive foreign goods—and in-

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creased foreign and military aid—caused many dollars to flow out of the country. As a result, the dollar's value declined greatly on the world's foreign exchange markets. U.S. economists deplore this decline in the purchasing power of the dollar because it tends to exacerbate inflation. A cheaper dollar fuels inflation because imported goods become more expensive to Americans (although it aids some American businesses operating abroad when goods exported to other countries become less expensive relative to their competition).

Inflation and the declining value of the dollar, added to the generally volatile nature of the world economy, have led many observers to call for adjustment or reform of the world economic system. Concrete efforts at reform had begun as early as 1944, when most of the world's leading nations sent representatives to a conference at Bretton Woods, New Hampshire. Here the World Bank and International Monetary Fund (IMF) were established, and a system of "pegged" or fixed exchange rates was devised.

The function of the World Bank is to promote world trade and economic development by making loans to nations that might not otherwise be able to raise the funds necessary for participation in the world market. The bank receives its capital from its member countries, which subscribe in proportion to their economic importance. Naturally, the members of the World Bank hope they will be paid back in full by nations that have used their loans to strengthen their weak economies. Eventually, it is hoped, these countries will have developed to such an extent that they can become full trading partners with the more developed countries, manufacturing their own products, and trading them for other goods.

The International Monetary Fund extends short-term credit to nations unable to meet their balance-of-payments debts by conventional means, usually increased exports and long-term loans. The IMF expects to be paid back and can enter into consultations with chronic debtor-nations in order to advise them on how best to repay their debts. The IMF will often ask these nations to take steps to decrease their imports or perhaps depreciate their currencies.

The conference at Bretton Woods also provided for fixed exchange rates between nations, but this part of the agreement has since been abandoned. In 1971, with the

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American trade deficit continuing to grow, the United States proposed that Germany and Japan, both with favorable balances of payment, appreciate their currencies. These nations were reluctant to act, and when they did, it was too little too late. The fixed value of the dollar was abandoned and allowed to "float;" that is, to fluctuate in comparison to other currencies—with supply and demand determining the value. In the United States prices and wages were frozen for a time, and a 10 percent surcharge was imposed on imports. The purpose was to persuade Europe and Japan to reduce trade barriers against American products.

A world conference was called at the Smithsonian Institution in Washington, D.C., to try and revive the old system. The dollar was officially devalued, and the Japanese yen and German mark were raised in value. When the U.S. trade position still did not improve enough in 1972, the fall of the dollar was made official, and the world reverted to flexible exchange rates.

Some economists argue that more potent methods must be used to correct long-term and deep-seated trade imbalances. Two of the more popular ideas are the use of flexible exchange rates and special drawing rights (SDRs). Flexible exchange rates would mark a compromise between the days of rigid (and usually outdated) exchange rates and today's free-floating situation where supply and demand can cause extreme fluctuations in a currency's value. Flexible exchange rates would allow a currency to fluctuate up to a certain prescribed level, perhaps 1 or 2 percent a year.

Special drawing rights are what is known as "paper gold." Limited supplies of gold relative to the world money supply, along with the fall in value of the dollar (which as the world's strongest currency had been used in lieu of gold to pay for international transactions), have led to the need to find an alternative. The IMF has responded by agreeing to create paper gold and distribute it to member nations in proportion to the amount of their subscription. Some poorer nations hope that the IMF will allow them a share of these drawing rights, based on need, that is out of proportion to their economic importance.

Large price increases by the Organization of Petroleum Exporting Countries (OPEC), along with a lingering

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memory of the oil embargo of 1974, disturb economists, who observe a growing American dependence for raw materials on outside sources. The energy shortage is important not only for the obvious economic dislocations it causes, but because it is related to other issues. For example, recent increases in the price of oil have worsened the nation's balance of payments. In addition, many other nations remain skeptical about the United States's resolve to solve its economic problems, claiming that it has not taken the steps necessary to develop a comprehensive plan of energy saving.

Within the United States, there has been much debate over whether or not such a crisis really exists. Some economic analysts believe that the world supply of precious minerals has been understated or that new finds (for example, Mexican oil fields) will be enough to take care of U.S. energy needs. Others argue that a shortage indeed does exist and that it is prudent for many reasons to begin preparing for an era of shortages.

A report issued in December 1974 (*Special Report: Critical Imported Materials*, Council on International Economic Policy) concluded that the United States was vulnerable to shortages of chrome, bauxite, and platinum. In 1973, the nation imported 100 percent of its chrome, bauxite, platinum, and tin; over 80 percent of its mercury, manganese, cobalt, and nickel; and more than 33 percent of its tungsten, zinc, lead, and titanium. The report pointed out that some metals were stockpiled by the government to provide for national security needs. There was enough tungsten for eight years, chrome and tin for four years, and manganese and lead for one year.

The United States also exports raw materials, especially food, coal, phosphates, softwood logs, and ferrous scrap. Copper goes in both directions in almost equal amounts.

While the United States depends increasingly on imports of raw materials, its needs are not nearly so great as those of Western Europe or Japan. The latter is 90 percent dependent on imports for raw materials. Significantly, except for petroleum, the United States does not rely heavily on developing countries. Two-thirds of the nations' imported raw materials (again excluding petroleum) come from Canada, Australia, and other more industrially devel-

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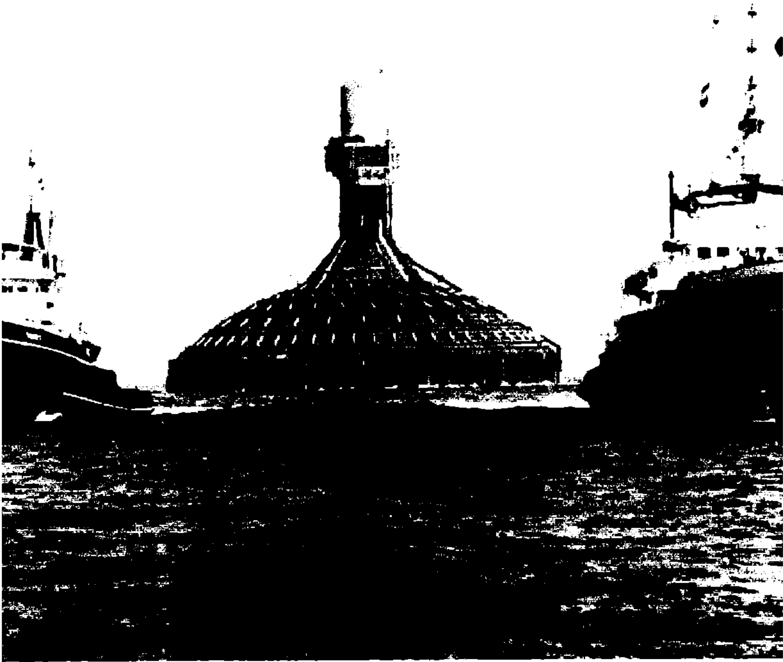

The United States is seeking alternate sources of energy to reduce its dependence on oil imported from such nations as the United Arab Emirates, which owns Khaszan Dubai I, a large underwater crude oil storage tank.

oped nations. But the importance of petroleum cannot be underestimated: it amounts to a third of U.S. imports.

The Growth of Interdependence

Increasing dependence of nations on others for precious raw materials is only one example of a general trend toward world interdependence. Much of the recent reform of the world economic system has been predicated on an understanding of this fact. In the last few years, the United States has itself come to recognize the necessity of integrating its economy with others of the world.

By 1973 there was growing understanding of the do-

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mestic consequences of international trade. Mounting worldwide inflation interfered with domestic price controls as goods left the American economy for export to markets abroad where higher prices were available. The Arab-Israeli War of that year brought the oil embargo and an acceleration of oil prices. But there was also a strong demand for American grain, as well as other products.

The governments of other nations expressed dismay when they learned that the American solution to this problem would be export controls. Foreign governments which had liberalized their trade policies found themselves dependent on American supplies that were no longer available. As a result of their protests, the United States began to modify its policies. Thus, President Richard Nixon stated in his Economic Report on February 1, 1974:

> **Events of 1973 brought our external economic relations sharply to our attention. Most simply put, it will be exceedingly hard for us to have a stable economy in an unstable world. We must contribute a stabilizing influence to the world economy of which we are a part. We must promote concerted efforts to maintain the health of the world economy.**

This official recognition of the interaction of the domestic and international economies was of historic importance. It was not based on cold war concerns of the past. Rather, it was an acknowledgment that henceforth the world market would be intertwined with the U.S. economy.

This stance has been criticized; it has also been tested by other events. One such test occurred late in 1974 when the Soviet Union entered the grain market and purchased substantial amounts of corn and wheat from private dealers. The Nixon Administration was shocked by this unprecedented purchase. The prices of grain and meat soared on American grocery shelves and meat counters. At the same time, there was not enough grain to supply needs of regular customers in other nations. The problem was softened through rapid and secret diplomacy with the Soviets, but it serves as a reminder of how large-scale sale of scarce commodities can greatly affect price stability.

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American foreign economic policy has also been tested by those who do not accept its overall direction. Elements of the labor movement in recent years have entered the debate and lent their weight to an increasingly protectionist stance. Their purpose is to protect themselves from competition with lower-paid workers abroad. In fact, the import rate on some goods has increased so rapidly that both industry and labor are alarmed and are demanding ceilings on imports in specific areas.

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AN AFTERWORD

We have already noted that there is a significant contradiction between the simple model that many economists ascribe to the market system and the factual history of the American experience. The United States has always relied to some degree upon the government as a creative economic agent. On the other hand, it has also always had some degree (at times a very large degree) of distrust of the competence of the political bureaucracy. Labor, agriculture, the small firm, the large corporation, the Federal Reserve System, and the government have all interacted to produce a most variegated history.

An introductory note to a previous chapter referred to the observation that reason and time are extremes. What we have presented here has been mostly the historical record as explained by reason, theory and past experience.

But what of the future? Doubtless the future is influenced by the past, but even the past is not without its contradictions. Furthermore, the future does not have to rely upon the past. To speculate on the future wisely is both difficult and courageous. In this chapter the hope is that the speculation merits commendation for both bravery and wisdom.

What comes next? In trying to answer such a seemingly simple question, many an economist has run into a brick wall. Predicting the future in any area, much less the dynamic, volatile field of economics, is a risky occupation. No one knows what new ideas, inventions, or technical applications are around the corner. In the past, such developments (and the effect on productivity rates they can induce) have had far-reaching consequences for the economic world. They have provided the answer to such questions as: Which industries will flourish or fail? What kind

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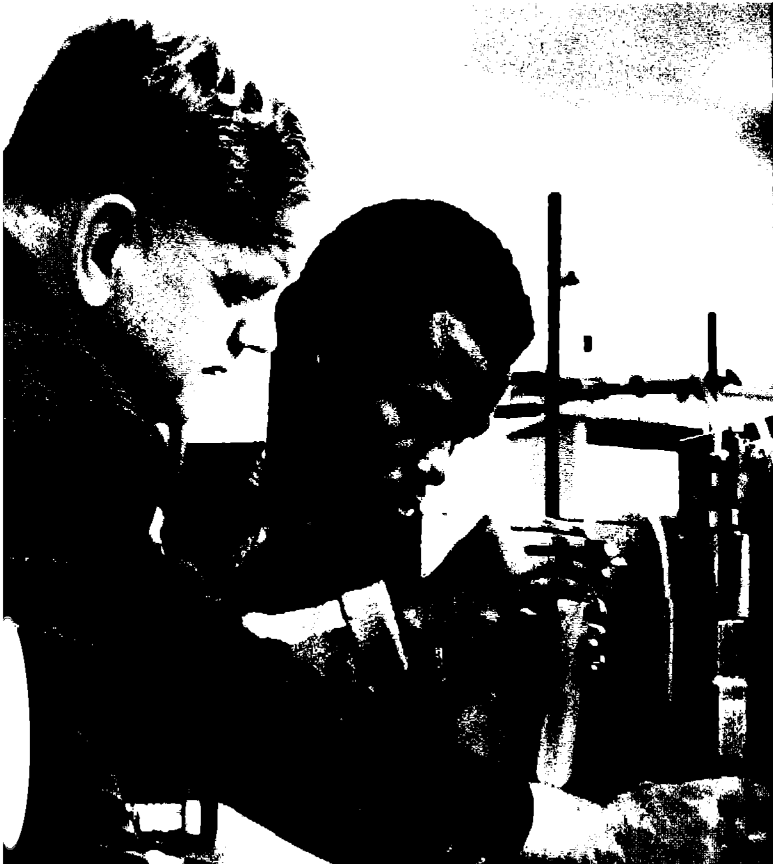
of jobs will be made available? What will be the standard of living for those who hold those jobs? It is likely that this long-range trend will continue. And if it seems futile to speculate as to the specifics of these changes, it might nevertheless be useful to discuss the context in which they will take place.

Inflation

It has become increasingly clear that the United States must find methods to control inflation, probably the single problem that most worries the average American. President Jimmy Carter noted that inflation is the cruelest tax

Research is a key to the economic viability of the future. At the University of Florida, an agronomy professor works with a graduate student from Uganda in an investigation of various forages for livestock feed.



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that anyone can pay. Many people agree with that sentiment, arguing that the persistent decline in the dollar's purchasing power hurts people directly because products cost more, and also causes a kind of psychological damage. Recent polls have shown that the average American, far from being optimistic, expects prices to rise to ever higher rates. In the short run this has caused consumers to maintain their levels of spending with the conviction that it is better to buy this year rather than next. But the question is: how long can this go on?

The American public recently has indicated its displeasure, and government has felt obliged to respond. The Federal Reserve Board of Governors has pushed interest rates higher and tried to control the supply of money through raising the reserve requirement, in hopes of limiting the amount of money in circulation. This traditional use of monetary policy has been endorsed by many leaders, but it has angered citizens, such as prospective home buyers, who need easy credit. This has led those concerned about inflation to advocate other methods of dealing with the problem, with many economists advocating a limit to government spending.

Long a popular issue with conservatives, the concept of limiting government spending has received new impetus. Proposals to cut the "fat" out of government—eliminating wasteful programs and agencies—are increasingly popular, as is a plan to reduce the sizable federal budget deficit. Advocates of these approaches hope that they can bring an end to inflation.

Those who propose cuts in spending have been encouraged by another recent phenomenon—the tax revolt. As of this writing, no one knows how long-lasting this movement will be, but those who favor dramatic slashes in the amount of taxes people have to pay, both at the local and federal levels, have won some impressive victories. That these victories are related to high inflation seems clear, especially in view of the fact that inflation pushes people into higher tax brackets under the U.S. progressive income tax system.

Critics of the so-called tax revolt claim that reductions in taxes—and consequently the level of government spending—will deny government assistance to poor people, who will suffer from reductions in welfare services and the

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closing of such essential services as schools, libraries, and parks.

The issue is clearly a complex one, made more so by the failure of traditional policies and maxims. For example, in the past, economists could rely on one small blessing—during times of inflation, unemployment levels would drop. This has not been the case recently, and the term "stagflation," which refers to an economy that evidences both high inflation and unacceptably high levels of unemployment, has entered the economic vocabulary. The danger in such a situation is readily apparent when one notes that the traditional methods used to boost employment levels, investment incentives, and government spending may well have a disastrous effect on the other half of the problem, inflation.

And so it is clear that most economic activity in the near future will be influenced by the nature of the battle against inflation. Decisions by industry, labor, and government will not be made in a vacuum. In addition, divergent elements of the public can be expected to continue to argue vigorously their positions.

Growth

The other major issue facing the American public has to do with growth. Despite periodic depression or recession, the economy has continued to grow. In fact, such growth has been seen as vital to the nation's continued prosperity. Companies have grown, diversified, and grown some more.

But during the past two decades, those who argue that growth cannot be maintained, or even that it must be forcibly contained, have won several victories in the continuing national debate. While not all the positions taken by no-growth advocates are necessarily correct, the days when uncontrolled growth was an unquestioned value are past. For example, developers are questioned today as never before. Environmental impact reports must be filed with government. Local planning commissions are more likely to be critical of proposed projects. And a proliferation of federal agencies, such as the Environmental Protection Agency, have been established, in the name of safe, considered economic planning.

As noted in the previous chapter, observers do not

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The U.S. government encourages youth employment by providing young people opportunities to learn job skills. These young men are in an on-the-job training program sponsored by the Manpower Development and Training Act.

seem to agree whether or not the world faces critical shortages of important raw materials. Such a debate might be ended by the compilation of objective facts, but increasingly, the debate over growth hinges on the subjective. How much pollution is too much? How much open space are we willing to eliminate in the attempt to create new jobs? These are hard questions that generate almost as many answers as there are interested parties. Certainly the United States has plenty of land left and resources with which to undertake new ventures—in housing, industry, and business. But the context in which many of these de-

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velopment decisions will be made will be increasingly open to public debate.

One area where the no-growth advocates are likely to succeed is in the role of government. We have noted how inflation and the tax revolt have generated serious discussion about the growth of government. It is apparent that some kind of governmental growth limits will be adopted, but the extent of the reduction is as yet unknown. The question facing government is: how to do all that is required of it—with limited funds. Will it maintain its role of watchdog and regulator? What will become of services provided by the various forms of government? Were these services necessary or useful in the first place? These are all questions that will be debated throughout the next decade. And as with the other issues discussed in this book, the effect on economic planning and decision-making will be substantial.

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