Economic Decision Makers

CHAPTER

3

1

Households

- Play the major role in U.S. economy
  - First, they demand goods and services from the product market thereby help determine what gets produced
  - Second, they supply the resources to resource markets thereby make what gets produced

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Households

- When U.S. was an agricultural economy, a farm household was largely self-sufficient → they produced what they consumed and consumed what they produced
- Improved farm productivity and the growth of urban factories increased the demand for factory labor and the movement from rural to urban America began

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Households

- Another dramatic change has been the increase of women in the labor force
- The increased opportunity cost of working in the home because of higher wages has led to the current situation where more than half of married women with children are in the labor force → less production takes place in the home and the female labor participation rate has increased

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Households

- The rise of two-earner households has affected the family as an economic unit
- Less production occurs in the home, and more goods and services are demanded from the market
- It has also reduce the advantages of specialization within the household

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Households as Demanders of Goods and Services

- On average, about 81 percent of U.S. personal income goes to personal consumption, about 3 percent is saved, and 16 percent goes for taxes
- Personal consumption is commonly divided into three categories.

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The Evolution of the Firm

- The combination of technological advances which increased worker productivity and contributed to the shift of employment from rural to urban areas
- Work became organized in large, centrally powered factories that
  - Promoted a more efficient division of labor
  - Facilitated the use of machines far bigger than anything that had been used in the home

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The Evolution of the Firm

- This transformation process is generally referred to as the Industrial Revolution
- Production evolved from self-sufficient rural households to the cottage industry, to the current system of handling production under one roof
- Firms are economic units formed by profit-seeking entrepreneurs who combine the resources to produce goods and services
  - We assume firms attempt to maximize profits → entrepreneur's reward = revenue minus cost of production

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Why Does Some Household Production Still Exist?

- Why hasn't all production shifted to firms?
  - Some activities require few skills or specialized resources
  - Household production avoids taxes
    - that is, the tax free nature of do it yourself activity favors household production over market transactions

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Why Does Some Household Production Still Exist?

- Why hasn't all production shifted to firms?
  - Household production has lower transaction costs
    - For example, if we want our house painted we could get bids from contractors, hire a contractor, negotiate terms, and monitor job performance. All of these tasks take time and require information →
    - Doing the job yourself reduces these transaction costs and allows for more personal control over the final product
  - Finally, various technological advances – dishwashers, microwave ovens, PC's, and so on – have all made household work more attractive

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Types of Firms: Sole Proprietorship

- Are approximately 25 million for-profit businesses in the United States which are organized in one of three ways
- Simplest form of business is the ***sole proprietorship*** which is a firm with a single owner who has the right to all profits → complete control
- Disadvantages
  - Unlimited liability for any business debts and can in fact lose personal assets
  - Difficult to raise capital

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Partnership

- Partnership is a firm with multiple owners who share the firms profits
  - Commonplace in law, accounting, and medical practice
- Often easier to raise sufficient funds to get the business going than with a sole proprietorship
- Disadvantages
  - Share Profit
  - Lose control

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Corporation

- Corporation is a legal entity owned by stockholders
- Advantages
  - First, and most important is that this is the easiest way to raise capital funds
  - Second, stockholders have limited liability ➔ their liability for any losses is limited to the value of their stock
  - Third, corporation has a life apart from its owners

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Corporation

- Disadvantages
  - Stockholder's ability to influence corporate policy is limited to voting for a board of directors. Each share of stock normally carries only one vote
  - Second, corporate income is taxed twice: first as corporate profits and second as stockholder income, either as corporate dividends or as realized capital gains
    - *Realized capital gain* is any increase in the market value of a share that occurs between the time the share is purchased and the time it is sold

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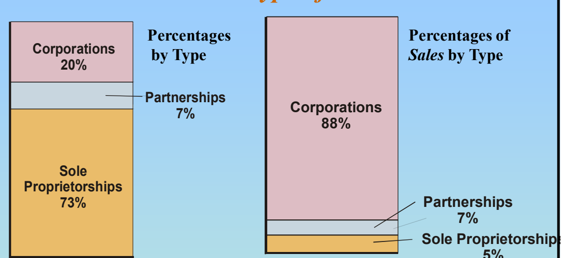
Exhibit 2: Number and Sales of Each Type of Firm



Corporations make up only 20% of all U.S. businesses but account for 88% of all sales. *Sole proprietorships* make up 73% of all U.S. businesses but account for only 5% of all sales.

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Government

- Unrestrained operation of markets sometimes yield undesirable results
- Sources of market failure and how society's overall welfare could at times be improved through government intervention

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Government

- Role of Government
  - Establishing and enforcing the rules of the game
  - Promoting competition
  - Regulating natural monopolies
  - Providing public goods
  - Dealing with externalities
  - More equal distribution of income
  - Full employment, price stability, and economic growth

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Inherent Inefficiencies

- Since the revenue side of the government budget is separate from the expenditure side there is no necessary link between the cost and benefit of a public program or good

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Size and Growth of Government

- One of most useful ways to track the role of government over time is to compare government spending to *gross domestic product*, or GDP
  - *GDP is the total value of all final goods and services produced in the United States*
  - In 1929, the year the Great Depression began, government spending, mostly by state and local governments, totaled about 10% of GDP
  - By 1992, government spending was 35 percent of GDP
  - By 2000 government outlays were 29% of GDP

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Size and Growth of Government

- Government outlays relative to GDP in other countries
  - 38% in Japan, the United Kingdom, and Canada
  - 43% in Germany
  - 47% in Italy
  - 51% in France
  - In the 36 largest industrial economies, the average was 36% of GDP in 2000

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Sources of Government Revenue

- Taxes are by far the largest source of revenue at all levels of government
- Federal government relies primarily on the individual income tax, state governments on income and sales taxes and local government on the property tax

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Tax Principles

- The structure of a tax system is often justified on the basis of one or two general principles
- *Ability-to-pay principle* is based on the premise that those with a greater ability to pay should pay more tax
- *Benefits-received tax principle* is based on the premise that those who receive more benefits from the government program funded by a tax should pay more tax

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Tax Incidence

- *Tax incidence* indicates who actually bears the burden of a tax
- The most common way of evaluating tax incidence is by measuring the tax as a percentage of income
  - Proportional taxation
  - Progressive taxation
  - Regressive taxation

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Tax Incidence

- *Proportional tax*
  - Taxpayers at all income levels pay the same percentage of their income in taxes
  - Also called a flat tax since the tax as a percentage of income remains constant as income changes
- *Progressive*
  - The percentage of income paid in taxes increases as income increases
- *Regressive*
  - The percentage of income paid in taxes decreases as income increases

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Marginal Tax Rate

- ***Marginal tax rate*** **measures the percentage of each additional dollar of income, assuming this is the appropriate base, that is paid as taxes**
- ***MTR = Δ Tax Liability / Δ Income***
- **Key here is that high marginal tax rates reduce the after tax return from working or investing → incentives to work or invest are reduced**

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Rest of the World

- **See Ch. 19 and 33**

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