Economics Handbook

NOTE: *Boldfaced words are terms that appear in this handbook.*

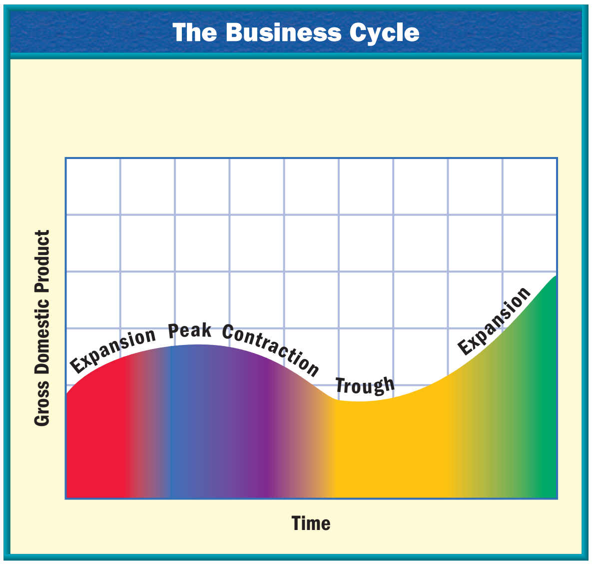
BOYCOTT *A refusal to have economic dealings with a person, a business, an organization, or a country.* The purpose of a boycott is to show disapproval of particular actions or to force changes in those actions. A boycott often involves an economic act, such as refusing to buy a company's goods or services.

African Americans in Montgomery, Alabama (shown below), organized a bus boycott in 1955 to fight segregation on city buses. The boycotters kept many buses nearly empty for 381 days. The boycott ended when the Supreme Court outlawed bus segregation.

American labor unions have sometimes used boycotts to win concessions for their members. Consumer groups, too, have organized boycotts to win changes in business practices.

BUSINESS CYCLE *A pattern of increases and decreases in economic activity.* A business cycle generally consists of four distinct phases—expansion, peak, contraction, and trough, as shown in the graph in the next column.

An expansion is marked by increased business activity. The **unemployment rate** falls, businesses produce more, and consumers buy more goods and services. A peak is a transition period in which expansion slows. A contraction, or **recession,** occurs when business activity decreases. The unemployment rate rises, while both production and consumer spending fall. A deep and long-lasting contraction is called a **depression.** Business activity reaches its lowest point during a trough. After time, business activity starts to increase and a new cycle begins.



CAPITALISM *An economic system in which there is private ownership of natural resources and capital goods.* The basic idea of capitalism is that producers are driven by the desire to make a profit—the money left over after costs have been subtracted from revenues. This desire for profit motivates producers to provide consumers with the goods and services they desire. Prices and wages are determined by **supply and demand.**

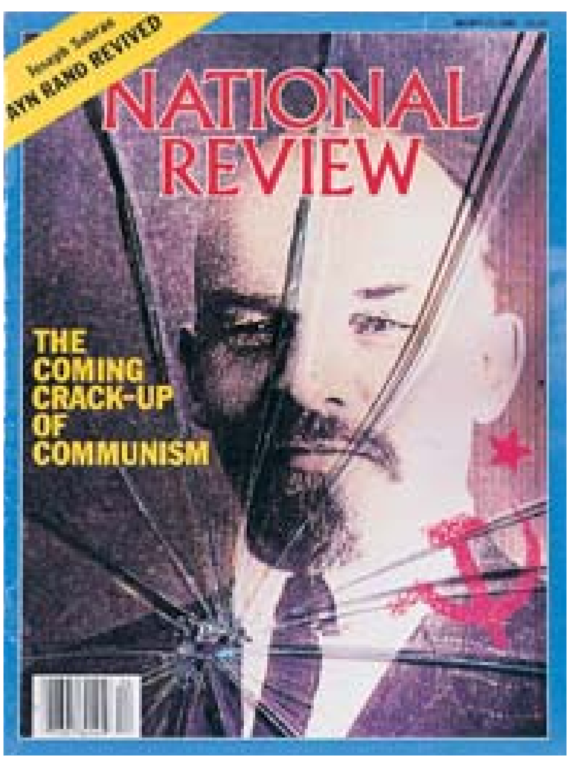
Along with the opportunity to earn a profit there is a risk. Businesses tend to fail if they don't produce goods people want at prices they are willing to pay. Because anyone is free to start a business or enterprise, a capitalist system is also known as a **free enterprise** system.

Capitalism contrasts with **socialism,** an economic system in which the government owns and controls capital and sets prices and production levels. Critics of capitalism argue that it allows decisions that ought to be made democratically to be made instead by powerful business owners and that it allows too-great disparities in wealth and well-being between the poor and the rich.

COMMUNISM *An economic system based on one-party rule, government ownership of the means of production, and decision making by centralized authorities.* Under communism there is little or no private ownership of property and little or no political freedom. Government planners make economic decisions, such as which and how many goods and services should be produced. Individuals have little say in a communist economy. Such a system, communists believe, would end inequality. For more information on the ideas on which communism is based, read the Economic Background on page 619.

During the 20th century, most communist economies failed to achieve their goals. Economic decisions frequently were made to benefit only Communist Party officials. Also, government economic planning was inefficient, often creating shortages of goods. Those goods that were available were often of poor quality.

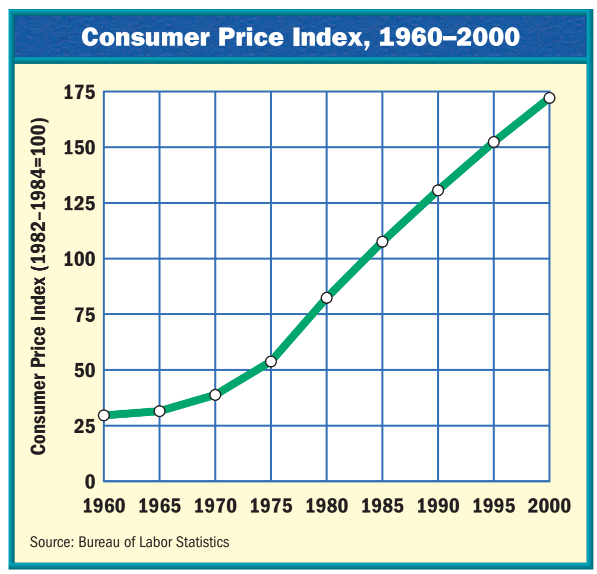
People became discontented with the lack of prosperity and political freedom and began to call for change. These demands led in the late 1980s and early 1990s to the collapse of communist governments in the Soviet Union and Eastern Europe.



Even governments that clung to communism introduced elements of **free enterprise.** Some communist countries—such as China—have experienced economic growth but have not granted more political freedom to their citizens.

CONSUMER PRICE INDEX (CPI) *A measure of the change in cost of the goods and services most commonly bought by consumers.* The CPI notes the prices of over 200 goods and services bought by average urban consumers on a regular basis. Items on which consumers spend a good deal of their income—such as food and housing—are given more weight in the CPI than items on which consumers spend less.

Price changes are calculated by comparing current prices with prices at a set time in the past. In 2001, for example, the CPI used the period from 1982 to 1984 as this base. Prices for this period are given a base value of 100. The prices for subsequent years are expressed as percentages of the base. Therefore, a CPI of 160 means that prices have risen by 60 percent since 1982–1984. The graph below illustrates changes in the CPI from 1960 to 2000.



DEFICIT SPENDING *A situation in which a government spends more money than it receives in revenues.* For the most part, the government engages in deficit spending when the economy is in a contraction phase of the **business cycle.** The government borrows or issues money to finance deficit spending.

In theory, the extra funds should stimulate business activity, pushing the economy into an expansion phase. As the economy recovers, revenues should increase, providing the government with a budget surplus. The government then can use the surplus to pay back the money it borrowed. For more information on deficit spending, read the Economic Background on page 698.

DEPRESSION *A very severe and prolonged contraction in economic activity.* During a depression, consumer spending, production levels, wages, prices, and profits fall sharply. Many businesses fail, and many workers lose their jobs.

The United States has experienced several economic depressions in its history. The worst was the Great Depression, which started in 1929 and lasted throughout the 1930s. Between 1929 and 1932, business activity in the United States decreased by an average of 10 percent each year. During the same period, some 40 percent of the country's banks failed, and prices for farm products dropped more than 50 percent. By 1933, the worst year of the Great Depression, 25 percent of American workers were unemployed—some, like the man shown below, were reduced to selling apples on the street.

For a personal account of life during the Great Depression, view the *American Stories* video "Broke, but Not Broken: Ann Marie Low Remembers the Dust Bowl." For information about the effects of war on a depression, read the Economic Background on page 763.

E-COMMERCE *All forms of buying and selling goods and services electronically.* Short for "electronic commerce," e-commerce refers to business activity on the Internet and on private computer networks. There are two main types of e-commerce: business-to-consumer and business-to-business.

Consumer-related e-commerce includes sales to the public over the computer, usually through a seller's Web site. Many business transactions can be completed wholly electronically, such as sales of computer software, which can be paid for with a credit card number and delivered over the Internet directly to the buyer's computer. A growing proportion of financial transactions are also moving online, such as electronic banking and **stock market** trading, or e-trading. The convenience of online shopping has turned it into a booming enterprise. Between 1998 and 1999, for instance, U.S. consumer spending online grew from about $7.7 billion to more than $17 billion.

Business-to-business e-commerce is growing at an even greater rate, reaching nearly $177 billion in 1999. Much of that business includes Web site design and servicing and online advertising. Businesses also use networked computers to purchase supplies and merchandise and to access information from subscription services.

For many businesses, e-commerce is not only convenient but also cost-effective. On average, corporations spend $100 on paperwork alone each time they make a purchase. Moving those transactions online could save companies millions of dollars annually.

EMBARGO *A government ban on trade with another nation, commonly backed by military force.* In a civil embargo the nation imposing an embargo prevents exports to or imports from the country against which it has declared the embargo. A hostile embargo involves seizing the goods of another nation.

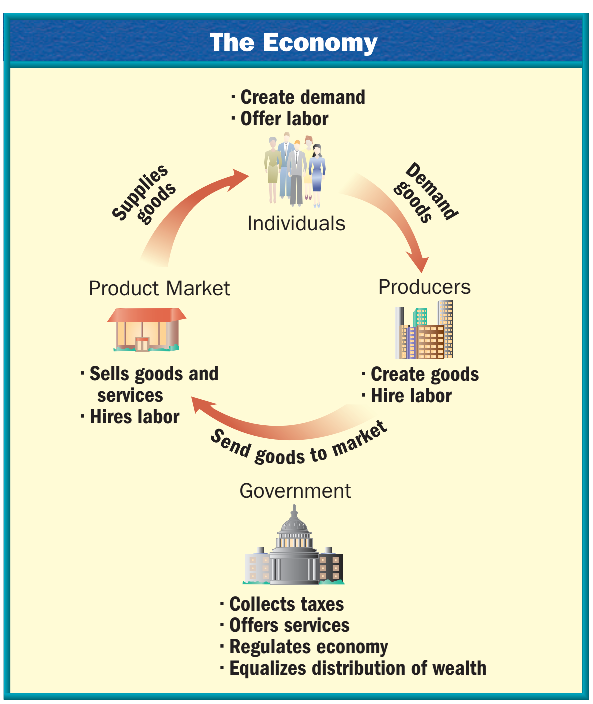
The major purpose of an embargo is to show disapproval of a nation's actions. For example, in 1980 the United States imposed a civil embargo on grain sales to the Soviet Union to protest the December 1979 Soviet invasion of Afghanistan.

FREE ENTERPRISE *An economic system based on the private ownership of the means of production, free markets, and the right of individuals to make most economic decisions.* The free enterprise system is also called the free market system or **capitalism.** The United States has a free enterprise economic system.

In a free enterprise system, producers and consumers are motivated by self-interest. To maximize their profits, producers try to make goods and services that consumers want. Producers also engage in competition—through lowering prices, advertising their products, and improving product quality—to encourage consumers to buy their goods. Consumers serve their self-interest by purchasing the best goods and services for the lowest price.

Government plays a limited, but important, role in most free-enterprise economies:

- It regulates economic activity to ensure there is fair competition, such as by preventing and prosecuting fraud and barring **monopolies.**
- It produces certain necessary goods and services that private producers consider unprofitable, such as roadways.
- It protects the public health and safety, such as through building codes, environmental protection laws, and labor laws.
- It provides economic stability, such as by regulating banks, coining money, and supervising unemployment insurance programs.

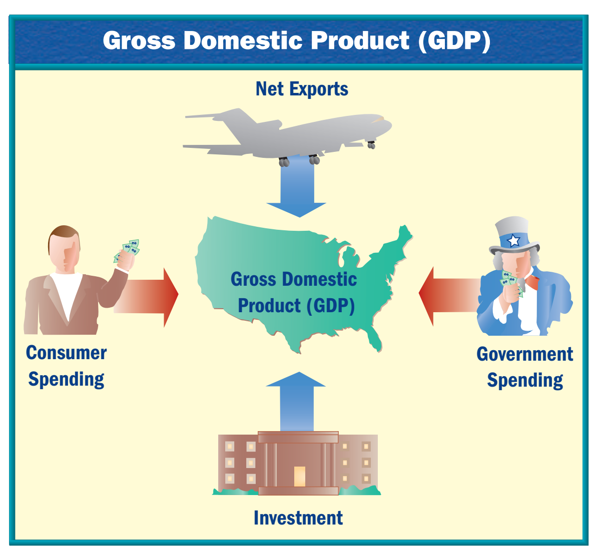


GOLD STANDARD *A monetary system in which a country's basic unit of currency is valued at, and can be exchanged for, a fixed amount of gold.* The gold standard tends to curb **inflation,** since a government cannot put more currency into circulation than it can back with its gold supplies. This gives people confidence in the currency.

This advantage is also a weakness of the gold standard. During times of **recession,** a government may want to increase the amount of money in circulation to encourage economic growth. Economic disruption during the Great Depression of the 1930s caused most nations to abandon the gold standard. The United States moved to a modified gold standard in 1934 and abandoned the gold standard completely in 1971.

GROSS DOMESTIC PRODUCT (GDP) *The market value of all the goods and services produced in a nation within a specific time period, such as a quarter (three months) or a year.* It is the standard measure of how a nation's economy is performing. If GDP is growing, the economy is probably in an expansion phase. If GDP is not increasing or is declining, the economy is probably in a contraction phase.

GDP is calculated by adding four components: spending by individual consumers on goods and services; investment in such items as new factories, new factory machinery, and houses; government spending on goods and services; and net exports—the value of exports less the value of imports. GDP figures are presented in two ways. Nominal GDP is reported in current dollars. Real GDP is reported in constant dollars, or dollars adjusted for **inflation.**



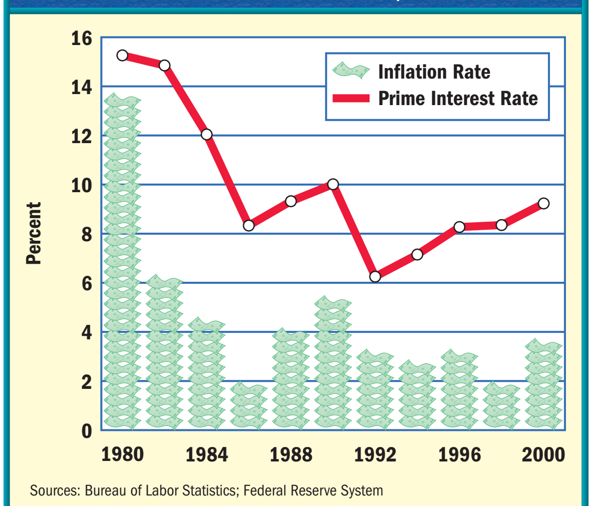
INFLATION *A sustained rise in the average level of prices.* Since more money is required to make purchases when prices rise, inflation is sometimes defined as a decrease in the purchasing value of money. Economists measure price changes with indexes. The most widely used index in the United States is the **consumer price index (CPI).**

Inflation may result if the demand for goods increases without an increase in the production of goods. Inflation may also take place if the cost of producing goods increases. Producers pass on increased costs, such as higher wages and more expensive raw materials, by charging consumers higher prices.

INTEREST RATE *The cost of borrowing money.* Interest is calculated as a yearly percentage, or rate, of the money borrowed. A 10 percent interest rate, therefore, would require a borrower to pay $10 per year for every $100 borrowed.

When interest rates are low, people will borrow more, because the cost of borrowing is lower. However, they will save and invest less, because the return on their savings or investment is lower. With high interest rates, people save and invest more but borrow less. Because interest rates affect the economy, the government takes steps to control them through the Federal Reserve System, the nation's central banking system. The graph below shows the relationship between the rate of **inflation** and interest rates over time.

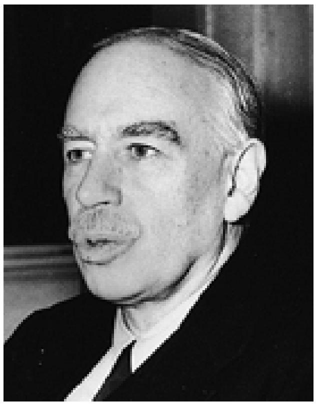
Inflation and Interest Rates, 1980–2000



Sources: Bureau of Labor Statistics; Federal Reserve System

KEYNESIAN ECONOMICS *The use of government spending to encourage economic activity by increasing the demand for goods.* This approach is based on the ideas of British economist John Maynard Keynes (shown below). In a 1936 study, Keynes pointed out that during economic downturns, more people are unemployed and have less income to spend. As a result, businesses cut production and lay off more workers.

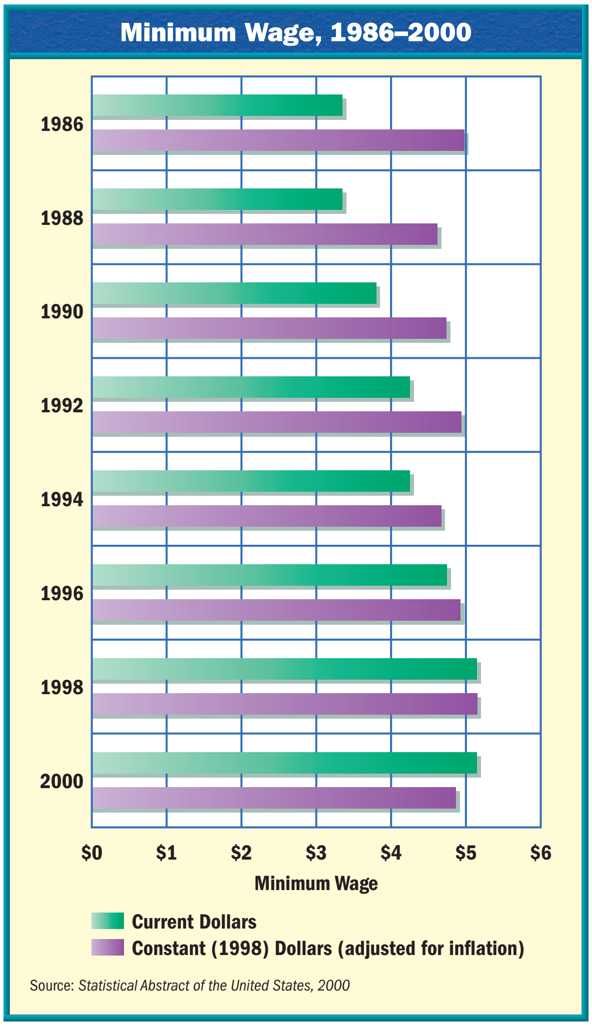
Keynes's answer to this problem was for government to increase spending and reduce **taxes.** This would stimulate demand for goods and services by replacing the decline in consumer demand. Government would want goods and services for its new programs. More people would be working and earning an income and, therefore, would want to buy more goods and services. Businesses would increase production to meet this new demand. As a result, the economy would soon recover.



Critics maintain, however, that Keynesian economics has led to the growth of government and to high taxes, inflation, high unemployment, and low economic growth. For an example of Keynesian economics at work, read the Economic Background on page 763.

MINIMUM WAGE *The minimum amount of money that employers may legally pay their employees for each hour of work.* The first federal minimum wage law, the Fair Labor Standards Act of 1938, set the base wage at 25 cents an hour. Since then, amendments to the act have raised this hourly rate to $5.15, effective in 1997. The Fair Labor Standards Act applies to workers in most businesses involved in interstate commerce.

The original intent of the minimum wage law was to ensure that all workers earned enough to survive. Some economists maintain that the law may have reduced the chances for unskilled workers to get jobs. They argue that the minimum wage raises the **unemployment rate** because it increases labor costs for business. The graph on the next page shows changes in the minimum wage over a ten-year period.



MONOPOLY *A situation in which only one seller controls the production, supply, or pricing of a product for which there are no close substitutes.* In the United States, basic public services such as electrical power distributors and cable television suppliers operate as local monopolies. This way of providing utilities is economically more efficient than having several competing companies running electricity or cable lines in the same area.

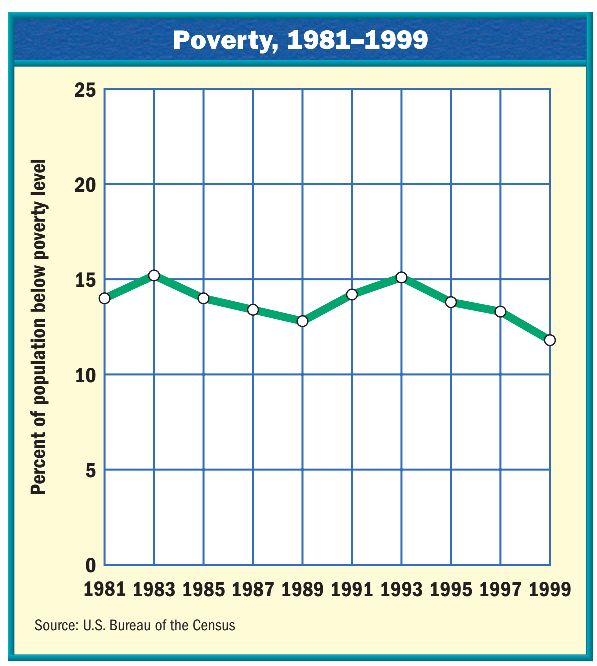
Monopolies, however, can be harmful to the economy. Since it has no competition, a monopoly does not need to respond to the wants of consumers by improving product quality or by charging fair prices. The government counters the threat of monopoly either by breaking up or regulating the monopoly.

NATIONAL DEBT *The money owed by a national government.* During wartime, during economic recession, or at other times, the government may employ **deficit spending.** However, the government may not pay back all the money it has borrowed to fund this policy. Each year's federal budget deficit adds to the national debt. By 2000, the national debt of the United States stood at $5.67 trillion, or about $20,000 for each citizen.

The rapid growth of the U.S. national debt since 1980 has prompted many Americans to call for changes in government economic policies. Some suggest that the government raise taxes and cut spending to reduce the debt. Others recommend a constitutional amendment that would require the government to have a balanced budget, spending only as much as it takes in.

POVERTY *The lack of adequate income to maintain a minimum* ***standard of living.*** In the United States, this adequate income is referred to as the poverty line. In 1999, the poverty threshold for a family of four was $17,029. That year, the poverty rate dropped to 11.8 percent—the lowest rate since 1979, and more than 32 million Americans lived in poverty.

While poverty rates have remained relatively steady over the last 30 or so years, inequality in the distribution of income has grown. Between 1970 and 2000, the share of income received by the wealthiest 20 percent of families increased from 43.3 percent to 56.7 percent. In the same period, the poorest 20 percent of families' share of income fell from 4.1 percent to 2.7 percent.



PRODUCTIVITY *The relationship between the output of goods and services and the input of resources.* Productivity is the amount of goods or services that a person can produce at a given time. It is closely linked to economic growth, which is defined as an increase in a nation's real **gross domestic product (GDP)** from one year to the next. A substantial rise in productivity means the average worker is producing more, a key factor in spurring economic expansion. Between 1995 and 2000, for example, worker productivity in the United States increased about 3 percent each year. This increase, along with other economic factors, helped the nation's real GDP grow an average of about 4 percent during those years.

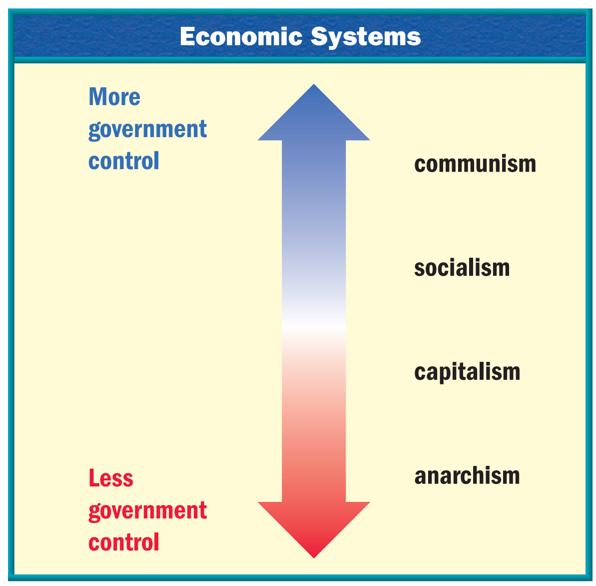
A number of elements affect productivity, including available supplies of labor and raw materials, education and training, attitudes toward work, and technological innovations. Computer technology, for instance, is believed to have played a significant role in bolstering productivity during the 1990s by allowing workers to do their jobs more quickly and efficiently. Conversely, a lack of adequate training and fewer innovations were thought to be behind the meager productivity growth rates of the 1970s and 1980s—when productivity rose at an annual rate of less than 1 percent.

RECESSION *A period of declining economic activity.* In economic terms, a recession takes place when the **gross domestic product** falls for two quarters, or six months, in a row. The United States has experienced several of these **business-cycle** contractions in its history. On average, they have lasted about a year. If a recession persists and economic activity plunges, it is called a **depression.** For more information on recessions, read the Economic Background on page 886.

SOCIALISM *An economic system in which the government owns most of the means of production and distribution.* Like **communism,** the goal of socialism is to use the power of government to reduce inequality and meet people's needs. Under socialism, however, the government usually owns only major industries, such as coal, steel, and transportation. Other industries are privately owned but regulated by the government. Government and individuals, therefore, share economic decision-making. Also, under socialism, the government may provide such services as reasonably priced health care.

Some countries, such as Sweden, are called democratic socialist countries. These nations have less government ownership of property than communist governments. They also have democratically elected governments.

Critics of socialism maintain that this system leads to less efficiency and higher taxes than does the **free enterprise** system.



STANDARD OF LIVING *The overall economic situation in which people live.* Economists differ on how best to measure the standard of living. Some suggest average personal income, while others propose per capita **gross domestic product**—the GDP divided by the population. Another possible measure is the value of the goods and services bought by consumers during a year. In general terms, the nation's standard of living rises as these measures rise. Some people argue that measuring the quality of life also requires consideration of noneconomic factors such as pollution, health, work hours, and even political freedom.

STOCK MARKET *or* STOCK EXCHANGE *A place where stocks and bonds are bought and sold.* Since stocks and bonds together are known as securities, a stock market is sometimes called a securities market.

Large companies often need extra money to fund expansion and to help cover operating costs. To raise money, they sell stocks, or shares of ownership, in their companies or borrow by issuing bonds, or certificates of debt, promising to repay the money borrowed, plus interest.

Individuals invest in securities to make a profit. Most stockholders receive dividends, or a share of the company's profits. Bondholders receive interest. Investors may also make a profit by selling their securities. This sale of securities takes place in the stock exchange.

Stocks and bonds are traded on exchanges. The largest and most important exchange in the United States is the New York Stock Exchange (pictured below; for more information on the New York Stock Exchange, read the Now & Then on page 674). Activity on this and other exchanges often signals how well the economy is doing. A bull market—when stock prices rise—usually indicates economic expansion. A bear market—when stock prices fall—usually indicates economic contraction.

A rapid fall in stock prices is called a crash. The worst stock market crash in the United States came in October 1929. To help protect against another drastic stock market crash, the federal government set up the Securities and Exchange Commission (SEC), which regulates the trading of securities.

Selected World Stock Exchanges

Exchange	Products
New York Stock Exchange (NYSE)	stocks, bonds
American Stock Exchange (AMEX) (New York)	stocks, bonds
National Association of Securities Dealers Automated Quotations (NASDAQ)	over-the-counter stocks
London Stock Exchange	stocks
Tokyo Stock Exchange	stocks, bonds, futures, options
Hong Kong Stock Exchange	stocks, bonds, mutual funds
German Stock Exchange (Frankfurt)	stocks

STRIKE *A work stoppage by employees to gain higher wages, better working conditions, or other benefits.* Strikes are also sometimes used as political protests. A strike is usually preceded by a failure in collective bargaining—the negotiation of contracts between labor unions and employers. Union members may decide to call a strike if they believe negotiations with the employer are deadlocked. Collective bargaining and strikes are regulated by the NLRA, or Wagner Act, of 1935, administered by the National Labor Relations Board (NLRB). There are also wildcat strikes, which do not involve unions.

When strikes do occur, union representatives and employers try to negotiate a settlement. An outside party is sometimes asked to help work out an agreement.

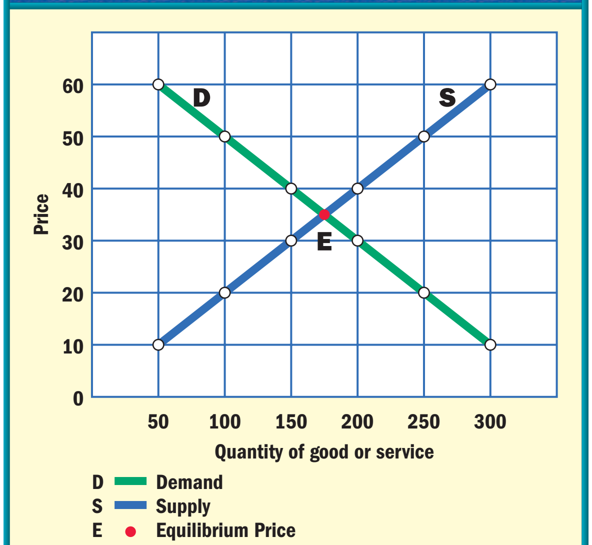
For a personal account of a strike, view the *American Stories* video, "A Child on Strike: The Testimony of Camella Teoli, Mill Girl.

SUPPLY AND DEMAND *The forces that determine prices of goods and services in a market economy.* Supply is the amount of a good or service that producers are willing and able to produce at a given price. Demand is the amount of a good or service consumers are willing and able to buy at a given price. In general, producers are willing to produce more of a good or service when prices are high; conversely, consumers are willing to buy more of a good or service when prices are low.

The table and graph below show supply and demand for a certain product. The line *S* shows the amount of the good that producers would be willing to make at various prices. The line *D* shows the amount that consumers would be willing to buy at various prices. Point *E*, where the two lines intersect, is called the equilibrium price. It is the price at which the amount produced and the amount demanded would be the same.

When the equilibrium price is the market price, the market operates efficiently. At prices above the equilibrium price, consumers will demand less than producers supply. Producers, therefore, will have to lower their prices to sell the surplus, or excess, products. At prices below equilibrium, consumers will demand more. Producers will be able to raise their prices because the product is scarce, or in short supply.

Supply and Demand



Supply and Demand Schedules

Supply	Price	Demand
50	10	300
100	20	250
150	30	200
200	40	150
250	50	100
300	60	50

SUPPLY-SIDE ECONOMICS *Government policies designed to stimulate the production of goods and services, or the supply side of the economy.* Supply-side economists developed these policies in opposition to **Keynesian economics.**

Supply-side policies call for low tax rates particularly in income from investments. Lower taxes mean that people keep more of each dollar they earn. Therefore, supply-side economists argue, people will work harder in order to earn more. They will then use their extra income to save and invest. This investment will fund the development of new businesses and, as a result, create more jobs. For more information on supply-side economics, read the Economic Background on page 1041.

TARIFF *A fee charged for goods brought into a state or country from another state or country.* Beginning in 1789, Congress created tariffs to raise revenue and to protect American products from foreign competition. Soon, however, special interest groups used tariffs to protect specific industries and increase profits.

Trade without tariffs is called free trade. In recent decades, a growing number of U.S. economists have favored free trade policies because they believe that such policies will help increase U.S. exports to other countries. In 1994, the North American Free Trade Agreement (NAFTA) established a free-trade zone among the United States, Canada, and Mexico.

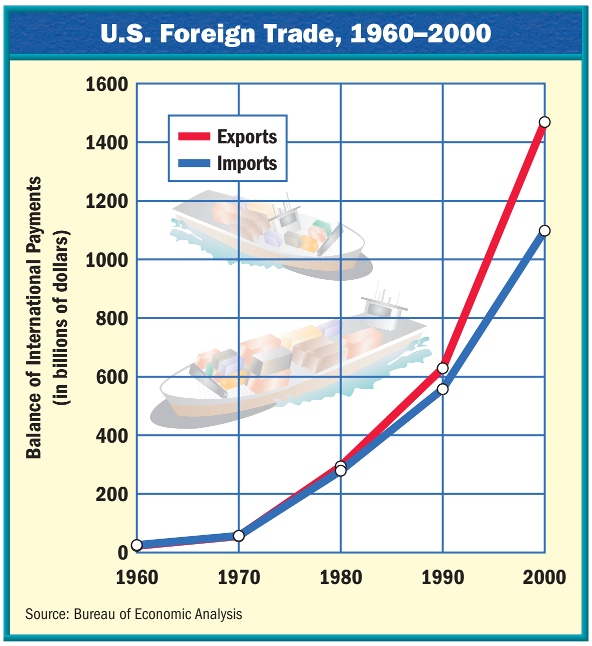
TAXATION *The practice of requiring persons, groups, or businesses to contribute funds to the government under which they reside or transact business.* All levels of government—federal, state, and local—collect many kinds of taxes. Income taxes are the chief source of revenue for the federal government and an important revenue source for many states. Both corporations and individuals pay income tax, or taxes on earnings. Since its inception in 1913, the federal income tax has been a progressive tax, one that is graduated, or scaled, such that those with greater incomes are taxed at a greater rate.

Sales taxes are another important source of income for state governments.

Property taxes are the main source of funds for local governments. Property tax is calculated as a percentage of the assessed value of real estate —land and improvements such as buildings.

TRADE *The exchange of goods and services between countries.* Almost all nations produce goods that other countries need, and they sell (export) those goods to buyers in other countries. At the same time, they buy (import) goods from other countries as well. For example, Americans sell goods such as wheat to people in Japan and buy Japanese goods such as automobiles in return.

Nations that trade with one another often become dependent on one another's products. Sometimes this brings nations closer together, as it did the United States, Great Britain, and France before World War I. Other times it causes tension among nations, such as that between the United States and Arab oil-producing countries in the 1970s. For an example of how trade influences foreign policy, read the Economic Background on page 583.



TRUST *A form of business merger in which the major stockholders in several corporations turn over their stock to a group of trustees.* The trustees then run the separate corporations as one large company, or trust. In return for their stock, the stockholders of the separate corporations receive a share of the trust's profits.

American business leaders of the late 1800s used trusts to stifle competition and take control of entire industries, as in a **monopoly.** Trusts were outlawed by the Sherman Antitrust Act of 1890. However, business leaders eventually found other ways to merge corporations in an industry.

UNEMPLOYMENT RATE *The percentage of the labor force that is unemployed but actively looking for work.* The labor force consists of all civilians 16 years of age and older who are employed or who are unemployed but actively looking and available for work. The size of the labor force and the unemployment rate are determined by surveys conducted by the U.S. Bureau of the Census.

The unemployment rate provides an indicator of economic health. Rising unemployment rates signal a contraction in the economy, while falling rates indicate an economic expansion. The graphs below show two different methods of portraying unemployment in the United States.