

The Institutions of a Market Economy: The Case of the United States

- Factors Affecting U.S. Development
- Business Structure
- Labor Markets
- Financial markets
- Governmental institutions:
 - Role in Allocation and Production
 - Role in Distribution
 - Legal System
 - Tax System
 - Effect of Government on Growth, Stability
 - Government Debt and Savings
 - Trade Policy

Factors Affecting U.S. Development

Natural Environment:

- Rich in natural resources.

Cultural Factors:

- Strong "protestant ethic" of Calvinism, Lutheranism; Horatio Alger mythology.
- Philosophy of individualism, anti-government attitudes.
- Immigration, slavery, and expansion led to "melting pot" issues – problems of discrimination, attitudes towards redistribution, now a growing tolerance of diversity.

Historical Factors:

- The "Frontier" – "free" natural resources, rural wage parity, opportunity for wealth.
- North vs. South – tensions over trade vs. protectionism, role of federal government, industry vs. slavery. Civil War decided in favor of federal power, protectionism, and industry.

Business Structure

- Agriculture majority of GDP until 1870, largest sector until 1900.
- Not the birthplace of the industrial revolution, but economy characterized by increasing innovation, especially interchangeable parts, mass production techniques, and retail.
- Industry replaced by services in 1950s.
- Legal development of the limited liability corporation, and innovation of new corporate structures (e.g., the U-form and M-form of large conglomerates). Corporations controlled by stockholders through board, relatively independent of banks.
- During the "Gilded Age" – industrial and retail expansion, age of monopolies, trusts, and "Robber Barons" – "The Public be Damned!"
- Antitrust Movement – Sherman Antitrust Act (1890), Clayton Act (1914). Slowing concentration ratios for manufacturing 1899-1958, increasing competitiveness through 1980s, greater tolerance of mergers, less antitrust enforcement, after 1980.
- Regulation of Natural Monopolies (ICC, FCC, PUCs, et cetera).
- Most firms are sole proprietorships, but most output comes from corporations. Majority of labor force still works in firms smaller than 100 employees.

Labor Markets and Unions

Relatively market-based labor market, but still there is regulation: low minimum wage (relative to history, other developed countries), payroll taxes, overtime regulation, layoffs relatively easy, unemployment insurance, worker safety (OSHA).

Rise of Unions:

- In 1880s, unions radical and unsuccessful – 8-hour movement, Knights of Labor, Haymarket riots.
- AFL (1886) founded on Gompers' "pure and simple unionism." CIO split in 1935, later rejoined.
- Norris-LaGuardia Act (1932) – full freedom of association, self-organization, et cetera.
- Wagner Act (1935) – NLRB, union of workers' choice, collective bargaining, banned unfair labor practices.
- Taft-Hartley Act (1947) passed over Truman's veto – cooling-off period, Federal mediation, no right to strike for government employees.
- Unions pushed for other labor market regulation – minimum wages, OSHA, et cetera.
- Unions declining in labor share since 1950s.

U.S. Financial Markets

- Anglo-American "model" of separating debt and equity. Banks and borrowers are relatively independent.
- Banking sector relatively deregulated.
- Banks very consumer-oriented, relatively high (and growing) consumer debt: mortgages, credit cards, other loans.
- Low personal savings rate.
- Explicit deposit guarantees through FDIC, FSLIC.
- Higher money velocity (i.e., relatively less money demand) than Japan, France, or Germany.
- High financial ratio: much higher stock market capitalization, large public and private bonds market, etc.
- U.S. Federal Reserve System created in 1913: quasi-independent monetary policy, lender of last resort, lead regulator over lending practices.

- Financial Policy:
 - Liberalization vs. repression
 - Prudential regulation, contagion problems, financial crises
 - Central bank is chief regulator, lender of last resort in U.S.

Government Institutions

Role in Allocation and Production:

- Military – Federal government tends to be sole purchaser.
- Highways – Federal government provides grants to states.
- State production – limited to education, post, administration.
- State ownership – limited to public lands, military bases, government buildings.
- Police, fire protection, education, etc. mostly provided by states.
- Health care largely private (except for Medicare, Medicaid as single payers, V.A. as provider).
- Product Market Regulation – pricing (e.g., utilities), consumer safety.
- Environmental Policy – natural resource use, endangered species, air and water quality.

Role in Distribution:

- Welfare reform in 1990s limited most poverty subsidies.
- Redistribution in-kind: public housing, food stamps.
- Social Safety Net: Social Security, Medicare are "pay-as-you-go."
- Limited unemployment insurance.
- Political preference for "tax expenditures."

Evolution of U.S. Government

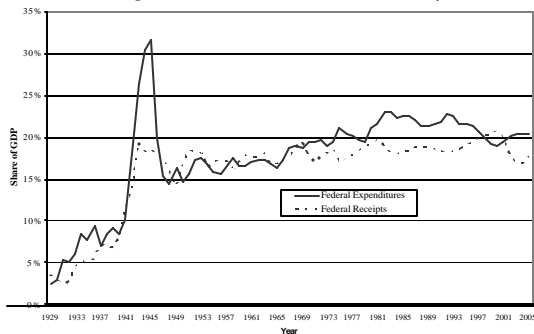
- Federal government small, policies very laissez faire until Civil War. Import duties primary revenue.
- Federal land grants to railroads, colleges.
- Populist movement – ICC, free silver movement.
- Progressive Era – trustbusting, FDA (*The Jungle*), Federal Reserve Bank, income tax during WWI.
- Great Depression – Roosevelt's "New Deal" increased role and responsibility of government, including Social Security.
- Truman's Full Employment Act of 1946 gave federal government responsibility for macroeconomics.
- World War II, Korean War, and Cold War – more powers to federal government.
- Johnson's Great Society Programs – Medicare, War on Poverty underfunded due to effort to hide costs of Vietnam War. Rising inflation during 1970s.
- Environmental protection (Nixon).
- Deregulation Era – began with airlines (Carter, 1978), then expanded under Reagan and continued through Clinton.

U.S. Government Spending over Time

Average Share of GDP	Total Federal Spending	Net State and Local Spending	Total Govt Spending	Total Govt Surplus
1929-1932	4.0%	7.2%	11.2%	0.4%
1932-1940	8.0%	7.2%	15.2%	0.0%
1941-1945	23.5%	4.2%	27.8%	-6.2%
1946-1950	16.2%	4.9%	21.1%	0.7%
1951-1960	16.6%	5.6%	22.2%	1.7%
1961-1970	17.8%	7.7%	25.4%	0.9%
1971-1980	19.9%	9.3%	29.2%	-1.3%
1981-1985	22.5%	9.7%	32.2%	-3.5%
1986-1990	21.8%	10.4%	32.1%	-2.7%
1991-1995	22.1%	10.9%	33.0%	-3.6%
1996-2000	20.0%	10.4%	30.4%	0.7%
2001-2005	20.1%	10.7%	30.9%	-2.4%

Growth of the federal government

Figure 1: Federal Government's Share of the Economy



Legal System

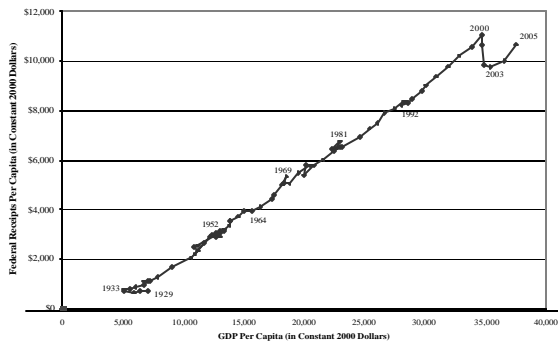
- ❖ 1787 Constitution – longest-lived constitutional democracy
 - ❖ federal system
 - ❖ three-branched government, bicameral legislature
 - ❖ system of political checks and balances
 - ❖ experiment in individual rights and self-government
- ❖ Legal system derived from British common law
 - ❖ Reliance on precedent, evidence, equality before the law
 - ❖ Different standards for criminal and civil law
 - ❖ Property rights – formal rights follow actual use
 - ❖ Public enforcement of private contracts, compensation, bankruptcy
- ❖ Accounting and financial disclosure
- ❖ Eminent Domain – public use of private property, with compensation
 - ❖ Controversy over compensation for zoning, regulation

Tax System

- Taxes are necessary to fund public goods, but taxes and subsidies create a deadweight loss. May sometimes offset market failures.
- Personal income tax, payroll taxes currently account for almost 90% of federal revenue.
- State and local governments depend mostly on property taxes, sales taxes.
- Redistribution of income – prior to 1964, 1981, 1986, income tax was significantly progressive.
- Currently, maximum federal tax rate < 40%, Social Security and Medicare contributions capped, some states have income taxes.
- Capital gains taxed at lower rate, double taxation of dividends.

Taxes have risen with income (until just recently)

Figure 2: The Relationship between Income and Taxes



Stabilization Policy

U.S. Full Employment Act makes federal gov't responsible for economic stability.

Fiscal Policy:

- Increasing overall spending by increasing government expenditures, cutting taxes.
- Keynesian countercyclical demand management, should be balanced over business cycle.
- Budget deficits lead to more debt, which leads to more interest expenditures.
- Budget deficits may cause more foreign borrowing, trade deficits offset stimulus effect.

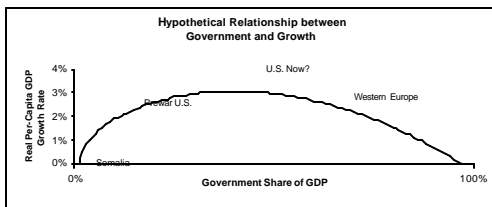
Monetary Policy:

- Money supply affects willingness to spend, depends on private deposit and lending cycle.
- Central bank increase bank reserves by buying assets (government bonds), can also affect banks willingness to lend.
- Seigniorage – central banks lend government with new money, so small deficits can be paid for if people are willing to hold it.
- If central bank lends too much, of course, inflation results.

Growth and Inflation by Period

Annualized Rates	Real GDP	Std. Dev.	Real GDP Per Capita	Inflation	Std. Dev.
1820-1910	3.9%	4.9%	1.5%	0.1%	6.6%
1910-1920	2.5%	6.5%	1.1%	8.0%	7.7%
1920-1930	2.7%	6.2%	1.1%	-2.1%	4.8%
1930-1940	2.7%	8.6%	1.2%	-1.6%	5.8%
1940-1950	5.5%	9.6%	3.3%	5.4%	4.0%
1950-1960	3.5%	3.1%	1.7%	2.4%	1.8%
1960-1970	4.2%	2.1%	2.9%	2.7%	1.6%
1970-1980	3.2%	2.6%	2.1%	7.0%	1.9%
1980-1985	3.2%	3.3%	2.3%	3.4%	2.6%
1985-1990	3.3%	0.8%	2.3%	2.7%	0.7%
1990-1995	2.5%	1.4%	1.2%	1.8%	0.6%
1995-2000	4.1%	0.7%	2.9%	1.3%	0.4%
2000-2005	2.6%	1.3%	1.5%	1.8%	0.4%

What is the relationship between government and growth?



The relationship between government and growth is probably shaped like an inverted U. Too much or too little government is bad for growth. It is not clear that the U.S. is on the downward-sloping portion.

U.S. Savings and Investment (2004)

Share of 2004 GDP	Gross Savings		Gross Investment	Capital Consumption	Net Investment
Household	1.3%	Residential	5.7%	2.0%	3.8%
Corporate	13.7%	Nonresidential	10.7%	8.3%	2.4%
Federal govt	-2.7%	Federal govt	0.9%	0.8%	0.1%
S&L govt	1.1%	S&L govt	2.3%	1.2%	1.2%
Foreign	5.6%	Total	19.6%	12.2%	7.4%
Gross Savings	19.0%	Statistical Discrepancy	-0.6%		

Gross I = Sp+Sg+Sf, Net I = Gross I – Depreciation (cap. con.)

Domestic Savings much less than Investment:

- High Private Consumption: 70% of GDP.
- Investment in new residential housing.
- Rising federal government deficits.
- Corporate savings relatively high.
- Large trade deficits offset by foreign savings inflows.

Why is this a Problem?

- Foreigners now own over half of U.S. Federal Debt.
- Americans consumption is high, so imports are high.
- Foreign savings keeps Dollar high → fewer exports.
- Looming retirement problem:
 - "Baby boom" retires, federal government treats current FICA surplus as government revenue, so "true" federal budget deficit is much higher.
- Speculative bubbles in stock market, then real estate.
- Markets currently still expect future depreciation of Dollar (oil futures high).
- Scary Scenario: Trade deficits, other concerns → depreciation of Dollar → slowing foreign savings inflows → rising interest rates → rising government interest expenditures, decline in private asset values → popping bubble, declining private wealth and consumption, rising government deficits, loss of faith in ability of federal government to repay, further depreciation of Dollar, inability to meet social security and medicare commitments.
- What are chances? Higher than 0%, lower than 50%.

International Trade

- Conflict between North and South over trade policy:
 - North – Hamilton's infant industry argument.
 - South – Plantation exports at low cost.
- After Civil War, policy became increasingly protectionist, ending with Smoot-Hawley Tariffs.
- Roosevelt, Cordell Hull, and the move to Free Trade: Reciprocal Trade Agreements Act, Bretton Woods, Havana Charter, GATT.
- Kennedy Round and exceptions to agriculture, multibres : Distributional vs. Encompassing interests.
- Strategic trade policy goals changed from before and after Cold War.
- Rising trade, increasing globalization, and competitive checks on monopoly power of large corporations.
- Factor price equalization and the backlash against trade.

Globalization

What is globalization?

- Economists focus on free trade in goods, services, labor, and capital, and the institutional rules that make this possible between (rather than just internal to) countries.
- There are also issues of cultural homogenization (e.g., a "race to the bottom" of a mass consumption society). Examples of baby milk powder, McDonald's, and clean bathrooms.
- Supporters of globalization usually assume perfect competition, while critics of it often argue that most trade tends to be controlled by large corporations. But trade would also lead to competition between large corporations in different countries that makes it harder for them to earn monopoly profits.

From the Lecture on the Neoclassical Model

International trade is particularly important because:

- Specialization and exchange according to comparative advantage improves efficiency.
- International finance is just trade in assets, rather than trade in goods, with the same results.
- An international division of labor leads to overall gains from trade that are shared among nations. The flow of goods, services, and capital between countries favors higher returns and lower costs.
- As a result the forces of supply and demand tend to lead towards an equalization of prices, wages, interest rates, and policies across nations, and thus tends to lead towards increasing economic convergence.
- Governments of countries which engage in global competition are less likely to get away with government intervention, since markets punish countries with inefficient policies (e.g., capital flees countries with high taxation or unstable monetary policies).

There are other relevant models:

- In the Leninist model, international trade and finance is an engine of capitalist exploitation and Imperialism. The popular version of this in the 1970s was called Dependency Theory, which focused on core and periphery. Newer theories have focused on the power of the multinational corporation relative to the government in third world country.
- Free trade is a prisoner's dilemma, where protectionism for each sector is the Nash equilibrium.
- In Olson's coalition theory, free trade is an encompassing issue, but protectionism is a distributional issue.
- In economic evolution, free trade leads to more competition and initially more variation, so this should lead to faster evolution. If this leads to convergence, of course, then worldwide variation will fall over time.
- Economists argue that protectionism gives more opportunities for corruption. But corruption may also allow a minority to inefficiently overexploit export natural resources owned by a majority with weak property rights.

Thomas Friedman's Lexus and the Olive Tree

Friedman is a journalist, not a scholar. He has not read most of prior original work on this subject, but he has written an intelligent, enthusiastic, interesting and controversial book.

- Argument that Globalization is THE new world system. Old system was the Cold War between the U.S. and the U.S.S.R.
 - Argument that future conflicts will primarily be between those who wish to hold on to their "ancient forces of culture, geography, tradition, and community" and the increasingly fast-paced, market-oriented, efficiency-focused, technologically-driven, and increasingly global economy. (Barber's Jihad vs. McWorld.)
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More on Friedman

- Globalization is not unprecedented, but it was interrupted by two world wars and the Cold War. (Role of transportation and communication.)
 - Three Democratizations: technology, finance, and information. These used to only be in the hands of the few. Globalization is thus about individuals, not just corporations.
 - A book full of metaphors, not theories: the electronic herd, the golden straightjacket, DOScapital, et cetera.
 - In his new book, The World is Flat, Friedman argues that in the last decade, the world has suddenly become much more globally competitive due to technological factors (the internet, transoceanic fiberoptics, outsourcing, etc.).
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