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Essay

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United States (Economy)

INTRODUCTION

The U.S. economy is immense. In 1998 it included more than 270 million consumers and 20 million businesses. U.S. consumers purchased more than $5.5 trillion of goods and services annually, and businesses invested over a trillion dollars more for factories and equipment. Over 80 percent of the goods and services purchased by U.S. consumers each year are made in the United States; the rest are imported from other nations. In addition to spending by private households and businesses, government agencies at all levels (federal, state, and local) spend roughly an additional $1.5 trillion a year. In total, the annual value of all goods and services produced in the United States, known as the Gross Domestic Product (GDP), was $9.25 trillion in 1999.

Those levels of production, consumption, and spending make the U.S. economy by far the largest economy the world has ever known—despite the fact that some other nations have far more people, land, or other resources. Through most of the 20th century, U.S. citizens also enjoyed the highest material standards of living in the world. Some nations have higher per capita (per person) incomes than the United States. However, these comparisons are based on international exchange rates, which set the value of a country's currency based on a narrow range of goods and services traded between nations. Most economists agree that the United States has a higher per capita income based on the total value of goods and services that households consume. American prosperity has attracted worldwide attention and imitation. There are several key reasons why the U.S. economy has been so successful and other reasons why, in the 21st century, it is possible that some other industrialized nations will surpass the U.S. standard of living. To understand those historical and possible future events, it is important first to understand what an economic system is and how that system affects the way people make decisions about buying, selling, spending, saving, investing, working, and taking time for leisure activities.

Capital, savings, and investment are taken up in the fourth section, which explains how the long-term growth of any economy depends upon the relationship between investments in capital goods (inventories and the facilities and equipment used to make products) and the level of saving in that economy. The next section explains the role money and financial markets play in the economy. Labor markets, the topic of section six, are also extremely important in the U.S. economy, because most people earn their incomes by working for wages and salaries. By the same token, for most firms, labor is the most costly input used in producing the things the firms sell.

The role of government in the U.S. economy is the subject of section seven. The government performs a number of economic roles that private markets cannot provide. It also offers some public services that elected officials believe will be in the best interests of the public. The relationship between the U.S. economy and the world economy is discussed in section eight. Section nine looks at current trends and issues that the U.S economy faces at the start of the 21st century. The final section provides an overview of the kinds of goods and services produced in the United States.

U.S. ECONOMIC SYSTEM

An economic system refers to the laws and institutions in a nation that determine who owns economic resources, how people buy and sell those resources, and how the production process makes use of resources in providing goods and services. The U.S. economy is made up of individual people, business and labor organizations, and social institutions. People have many different economic roles—they function as consumers, workers, savers, and investors. In the United States, people also vote on public policies and for the political leaders who set policies that have major economic effects. Some of the most important organizations in the U.S. economy are businesses that produce and distribute goods and services to consumers. Labor unions, which represent some workers in collective bargaining with employers, are another important kind of economic organization. So, too, are cooperatives—organizations formed by producers or consumers who band together to share resources—as well as a wide range of nonprofit organizations, including many charities and educational organizations, that provide services to families or groups with special problems or interests.

For the most part, the United States has a market economy in which individual producers and consumers determine the kinds of goods and services produced and the prices of those products. The most basic economic institution in market economies is the system of markets in which goods and services are bought and sold. That is where consumers buy most of the food, clothing, and shelter they use, and any number of things that they simply want to have or that they enjoy doing. Private businesses make and sell most of those goods and services. These markets work by bringing together buyers and sellers who establish market prices and output levels for thousands of different goods and services.

A guiding principle of the U.S. economy, dating back to the colonial period, has been that individuals own the goods and services they make for themselves or purchase to consume. Individuals and private businesses also control the factors of production. They own buildings and equipment, and are free to hire workers, and acquire things that businesses use to produce goods and services. Individuals also own the businesses that are established in the United States. In other economic systems, some or all of the factors of production are owned communally or by the government.

For the most part, U.S. producers decide which goods and services to make and offer to sell, and what prices to charge for those products. Goods are tangible things—things you can touch—that satisfy wants. Examples of goods are cars, clothing, food, houses, and toys. Services are activities that people do for themselves or for other people to satisfy their wants. Examples of services are cutting hair, polishing shoes, teaching school, and providing police or fire protection.

Producers decide which goods and services to make and sell, and how much to ask for those products. At the same time, consumers decide what they will purchase and how much money they are willing to pay for different goods and services. The interaction between competing producers, who attempt to make the highest possible profit, and consumers, who try to pay as little as possible to acquire what they want, ultimately determines the price of goods and services.

In a market economy, government plays a limited role in economic decision making. However, the United States does not have a pure market economy, and the government plays an important role in the national economy. It provides services and goods that the market

cannot provide effectively, such as national defense, assistance programs for low-income families, and interstate highways and airports. The government also provides incentives to encourage the production and consumption of certain types of products, and discourage the production and consumption of others. It sets general guidelines for doing business and makes policy decisions that affect the economy as a whole. The government also establishes safety guidelines that regulate consumer products, working conditions, and environmental protection.

Factors of Production

The factors of production, which in the United States are controlled by individuals, fall into four major categories: natural resources, labor, capital, and entrepreneurship.

Natural Resources

Natural resources, which come directly from the land, air, and sea, can satisfy people's wants directly (for example, beautiful mountain scenery or a clear lake used for fishing and swimming), or they can be used to produce goods and services that satisfy wants (such as a forest used to make lumber and furniture).

The United States has many natural resources. They include vast areas of fertile land for growing crops, extensive coastlines with many natural harbors, and several large navigable rivers and lakes on which large ships and barges carry products to and from most regions of the nation. The United States has a generally moderate climate, and an incredible diversity of landscapes, plants, and wildlife.

Labor

Labor refers to the routine work that people do in their jobs, whether it is performing manual labor, managing employees, or providing skilled professional services. Manual labor usually refers to physical work that requires little formal education or training, such as shoveling dirt or moving furniture. Managers include those who supervise other workers. Examples of skilled professionals include doctors, lawyers, and dentists.

Of the 270 million people living in the United States in 1998, nearly 138 million adults were working or actively looking for work. This is the nation's labor force, which includes those who work for wages and salaries and those who file government tax forms for income earned through self-employment. It does not include homemakers or others who perform unpaid labor in the home, such as raising, caring for, and educating children; preparing meals and maintaining the home; and caring for family members who are ill. Nor, of course, does it count those who do not report income to avoid paying taxes, in some cases because their work involves illegal activities.

Capital

Capital includes buildings, equipment, and other intermediate products that businesses use to make other goods or services. For example, an automobile company builds factories and buys machines to stamp out parts for cars; those buildings and machines are capital. The value of capital goods being used by private businesses in the United States in the late 1990s is estimated to be more than $11 trillion. Roughly half of that is equipment and the other half

buildings or other structures. Businesses have additional capital investments in their inventories of finished products, raw materials, and partially completed goods.

Entrepreneurship

Entrepreneurship is an ability some people have to accept risks and combine factors of production in order to produce goods and services. Entrepreneurs organize the various components necessary to operate a business. They raise the necessary financial backing, acquire a physical site for the business, assemble a team of workers, and manage the overall operation of the enterprise. They accept the risk of losing the money they spend on the business in the hope that eventually they will earn a profit. If the business is successful, they receive all or some share of the profits. If the business fails, they bear some or all of the losses.

Many people mistakenly believe that anyone who manages a large company is an entrepreneur. However, many managers at large companies simply carry out decisions made by higher-ranking executives. These managers are not entrepreneurs because they do not have final control over the company and they do not make decisions that involve risking the companies resources. On the other hand, many of the nation's entrepreneurs run small businesses, including restaurants, convenience stores, and farms. These individuals are true entrepreneurs, because entrepreneurship involves not merely the organization and management of a business, but also an individual's willingness to accept risks in order to make a profit.

Throughout its history, the United States has had many notable entrepreneurs, including 18th-century statesman, inventor, and publisher Benjamin Franklin, and early-20th-century figures such as inventor Thomas Edison and automobile producer Henry Ford. More recently, internationally recognized leaders have emerged in a number of fields: Bill Gates of Microsoft Corporation and Steve Jobs of Apple Computer in the computer industry; Sam Walton of Wal-Mart in retail sales; Herb Kelleher and Rollin King of Southwest Airlines in the commercial airline business; Ray Kroc of MacDonald's, Harland Sanders of Kentucky Fried Chicken (KFC), and Dave Thomas of Wendy's in fast food; and in motion pictures, Michael Eisner of the Walt Disney Company as well as a number of entrepreneurs at smaller independent production studios that developed during the 1980s and 1990s.

Acquiring the Factors of Production

All four factors of production—natural resources, labor, capital, and entrepreneurship—are traded in markets where businesses buy these inputs or productive resources from individuals. These are called factor markets. Unlike a grocery market, which is a specific physical store where consumers purchase goods, the markets mentioned above comprise a wide range of locations, businesses, and individuals involved in the exchange of the goods and services needed to run a business.

Businesses turn to the factor markets to acquire the means to make goods and services, which they then try to sell to consumers in product or output markets. For example, an agricultural firm that grows and sells wheat can buy or rent land from landowners. The firm may shop for this natural resource by consulting real estate agents and farmers throughout the Midwest. This same firm may also hire many kinds of workers. It may find some of its newly hired

workers by recruiting recent graduates of high schools, colleges, or technical schools. But its market for labor may also include older workers who have decided to move to a new area, or to find a new job and employer where they currently live.

Firms often buy new factories and machines from other firms that specialize in making these kinds of capital goods. That kind of investment often requires millions of dollars, which is usually financed by loans from banks or other financial institutions.

Entrepreneurship is perhaps the most difficult resource for a firm to acquire, but there are many examples of even the largest and most well-established firms seeking out new presidents and chief executive officers to lead their companies. Small firms that are just beginning to do business often succeed or fail based on the entrepreneurial skills of the people running the business, who in many cases have little or no previous experience as entrepreneurs.

Markets and the Problem of Scarcity

A basic principle in every economic system—even one as large and wealthy as the U.S. economy—is that few, if any, individuals ever satisfy all of their wants for goods and services. That means that when people buy goods and services in different markets, they will not be able to buy all of the things they would like to have. In fact, if everyone did have all of the things they wanted, there would be no reason for anyone to worry about economic problems. But no nation has ever been able to provide all of the goods and services that its citizens wanted, and that is true of the U.S. economy as much as any other.

Scarcity is also the reason why making good economic choices is so important, because even though it is not possible to satisfy everyone's wants, all people are able to satisfy some of their wants. Similarly, every nation is able to provide some of the things its citizens want. So the basic problem facing any nation's economy is how to make sure that the resources available to the people in the nation are used to satisfy as many as possible of the wants people care about most.

The U.S. economy, with its system of private ownership, has an extensive set of markets for final products and for the factors of production. The economy has been particularly successful in providing material goods and services to most of its citizens. That is even more striking when results in the U.S. economy are compared with those of other nations and economic systems. Nevertheless, most U.S. consumers say they would like to be able to buy and use more goods and services than they have today. And some U.S. citizens are calling for significant changes in how the economic system works, or at least in how the purchasing power and the goods and services in the system are divided up among different individuals and families.

Not surprisingly, low-income families would like to receive more income, and often favor higher taxes on upper-income households. But many upper-income families complain that government already taxes them too much, and some argue that government is taking over too many things in the economy that were, in the past, left up to individuals, families, and private firms or charities.

These debates take place because of the problem of scarcity. For individuals and governments, resources that satisfy a particular want cannot be used to satisfy other wants. Therefore,

deciding to satisfy one want means paying the cost of not satisfying another. Such choices take place every time the government decides how to spend its tax revenues.

What Are Markets?

Goods and services are traded in markets. Usually a market is a physical place where buyers and sellers meet to make exchanges, once they have agreed on a price for the product. One kind of marketplace is a grocery store, where people go to buy food and household products**.** However, many markets are not confined to specific locations. In a broader sense, markets include all the places and sources where goods and services are exchanged. For example, the labor market does not exist in a specific physical building, as does a grocery market. Instead, the term *labor market* describes a multitude of individuals offering their labor for sale as well as all the businesses searching for employees.

Traders do not always have to meet in person to buy and sell. Markets can operate via technology, such as a telephone line or a computer site. For example, stocks and other financial securities have long been traded electronically or by telephone. It is becoming increasingly common in the United States for many other kinds of goods and services to be sold this way. For instance, many people today use the Internet—the worldwide computer-based network of information systems—to buy airline tickets, make hotel reservations, and rent a car for their vacation. Other people buy and sell items ranging from books, clothing, and airline tickets to baseball cards and other rare collectibles over the Internet. Although these Internet buyers and sellers may never meet face to face the way buyers and sellers do in more traditional markets, these markets share certain basic features.

How a Single Market Works

Buyers hope to buy at low prices and will purchase more units of a product at lower prices than they do at higher prices. Sellers are just the opposite. They hope to sell at high prices, and typically they will be willing to produce and sell more units of a product at higher prices than at lower prices.

The price for a product is determined in the market if prices are allowed to rise and fall, and are not legally required to be above some minimum price *floor* or below some maximum price *ceiling*. When a product, for example, a personal computer, reaches the market, consumers learn what producers want to charge for it and producers learn what consumers are willing to pay. The interaction of producers and consumers quickly establishes what the market price for the computer will actually be. Some people who were considering buying a computer decide that the price is higher than they are willing to pay. And some producers may determine that consumers are not willing to pay a price high enough for them profitably to produce and sell this computer.

But all of the buyers who are willing and able to pay the market price get the computer, and all of the sellers willing and able to produce it for this price find buyers. If more consumers want to buy a computer at a specific market price than there are suppliers are willing to sell at that price—or in other words, if the quantity demanded is greater than the quantity supplied—the price for the computer increases. When producers try to sell more of their computers at a price higher than consumers are willing to buy, the quantity supplied exceeds the quantity demanded and the price falls.

The price stops rising or falling at the price where the amount consumers are willing and able to buy is just equal to the amount sellers are willing and able to produce and sell. This is called the market clearing price. Market clearing prices for many goods and services change frequently, for reasons that will be discussed below. But some market prices are stable for long periods of time, such as the prices of candy bars and sodas sold in vending machines, and the prices of pizzas and hamburgers. Most buyers of these products have come to know the general price they will have to pay for these items. Sellers know what prices they can charge, given what consumers will pay and considering the competition they face from other sellers of identical, or very similar, products.

A System of Markets for All Goods and Services

How markets determine price is simple enough to understand for a single good or service in a single location. But consider what happens when there are markets for nearly all of the goods and services produced and consumed in an economy, across the entire country. In that context, this reasonably simple process of setting market prices allows an economic system as large and complex as the U.S. economy to operate with great efficiency and a high degree of freedom for consumers and producers.

Efficiency here means producing what consumers want to buy, at prices that are as low as they can be for producers to stay in business. And it turns out this efficiency is directly linked to the freedom that buyers and sellers have in a market economy. No central authority has to decide how many shirts or cars or sandwiches to produce each day, or where to produce them, or what price to charge for them. Instead, consumers spend their money for the products that give them the most satisfaction, and they try to find the best deal they can in terms of price, quality, convenience, assurances that defective products will be replaced or repaired, or other considerations.

What consumers are willing and able to buy tells producers what they should produce, if they hope to make a profit. Usually consumers have many options to choose from, because more than one producer offers the same or reasonably similar products (such as two or more kinds of cars, colas, and carpets). Producers then compete energetically for the dollars that consumers spend.

Competition among producers determines the best ways to produce a good or service. For example, in the early 1900s automobiles were made largely by hand, one at a time. But once Henry Ford discovered how to lower the cost of producing cars by using assembly lines, other car makers had to adopt the same production methods or be driven out of business (as many were).

Competition also determines what features and quality standards go into products. And competition holds down the costs of production because producers know that consumers compare their prices to the prices charged by other firms and for other products they might buy. In markets where a large number of producers compete, inefficient producers will be driven out of the market.

For example, at one time most towns and cities had independently owned cafes and drive-in restaurants that sold hamburgers, french fries, and soft drinks. Some of these businesses are still operating, but many closed down after larger fast-food chains began opening local

franchises all around the nation, with well-known product standards and relatively low prices. The increased competition led to prices that were too low for many of the old cafes and drive-ins to make a profit. The private cafes that did survive were able to meet that level of efficiency, or they managed to make their products different enough from the national chains to keep their customers.

Prices for goods and services can only fall so far, however. Even the most efficient producers have to pay for the natural resources, labor, capital, and entrepreneurship they use to make and sell products. The market price cannot stay below the level of those costs for long without driving all of the producers out of this market. Therefore, if consumers want to buy some good or service not just today but also in the future, they have to pay a price at least high enough to cover the costs of producing it, including enough profit to make it worthwhile for sellers to stay in that market.

Once market prices for various goods and services are set, consumers are free to choose what to buy, and producers are free to choose what to produce and sell. They both follow their self-interest and do what makes them as well off as they can be. When all buyers and sellers do that in an economic system of competitive markets, the overall economy will also be very efficient and responsive to individual preferences.

This economic process is extremely decentralized. For example, it is likely that no one person or government agency knows how many corned beef sandwiches are sold in any large U.S. city on any given day. Individual sellers decide how many sandwiches they are likely to sell and arrange to have enough meat and bread available to meet the demand from their customers.

Consumers usually do not make up their mind about what to eat for lunch or dinner until they walk into the restaurant, grocery store, or sandwich shop. But they know they can go to several different places and choose many different things to eat and drink, while individual sellers know about how much they are likely to sell on an average business day.

Other businesses sell bread and meat and drinks to the restaurants and grocers, but they do not really know how many different sandwiches the different food stores are selling either. They only know how much bread and meat they need to have on hand to satisfy the orders they get from their customers.

Each buyer and seller knows his or her small part of the market very well and makes choices carefully to avoid wasting money and other resources. When everyone acts this carefully while facing competition from other consumers or producers, the overall system uses its scarce resources very efficiently. Efficiency implies two things here: taking into account the preferences and alternative choices that individual buyers and sellers face, and producing goods and services at the lowest possible cost.

How and Why Market Prices Change

Another advantage of any competitive market system is a high level of flexibility and speed in responding to changing economic conditions. In economies where government agencies and central planners set prices, it often takes much longer to adjust prices to new conditions. In the

last decades of the 20th century, the U.S. market economy has made these adjustments very quickly, even compared with other market economies in Western Europe, Canada, and Japan.

Market prices change whenever something causes a change in *demand* (the amount people are willing to buy at different prices) or a change in *supply* (the amount producers are willing and able to make and sell at different prices). *see* Supply and Demand. Because these changes can occur rapidly, with little or no advance warning, it is important for both consumers and producers to understand what can cause prices to rise and fall. Those who anticipate price changes correctly can often gain financially from their foresight. Those who do not understand why prices have changed are likely to feel bewildered and frustrated, and find it more difficult to know how to respond to changing prices. Market economies are, in fact, sometimes called *price systems*. It is important to understand why prices rise and fall to understand how a market system works.

Changes in Demand

Demand for most products changes whenever there is a significant change in the level of consumers' income. In the United States, incomes have risen substantially over the past 200 years. As that happened, the demand for most goods and services also increased. There are, however, a few products that people buy less of as income falls. Examples of these *inferior goods* include low quality foods and fabrics.

Demand for a product also changes when the price of a substitute product changes. For example, if the price for one brand of blue jeans sharply increases while other brands do not, many consumers will switch to the other brands, so the demand for those brands will increase. Conversely, if the price for beef drops, then many people will buy less pork and chicken.

Some products are complements rather than substitutes. Complements are products that are consumed together, for example cameras and film, or tennis balls and tennis rackets. When the price of a complementary good rises, the demand for a product falls. For example, if the price of cameras rises, the demand for film will fall. On the other hand, if the price of a complementary good falls, the demand for a product will rise. If the price of tennis rackets falls, for example, more people will buy rackets and the demand for tennis balls will increase.

Demand can also increase or decrease as a product goes in or out of style. When famous athletes or movie stars create a popular new look in clothing or tennis shoes, demand soars. When something goes out of style, it soon disappears from stores, and eventually from people's closets, too.

If people expect the price of something to go up in the future, they start to buy more of the product now, which increases demand. If they believe the price is going to fall in the future, they wait to buy and hope they were right. Sometimes these choices involve very serious decisions and large amounts of money. For example, people who buy stocks on the stock market are hoping that prices will rise, while at least some of the people selling those stocks expect the prices to fall. But not all economic decisions are this serious. For example, in the 1970s there was a brief episode when toilet paper disappeared from the shelves of grocery stores, because people were afraid that there were going to be shortages and rising prices. It

turns out that some of these unfounded fears were based on remarks made by a comedian on a late-night talk show.

The final factor that affects the demand for most goods and services is the number of consumers in the market for a product. In cities where population is rising rapidly, the demand for houses, food, clothing, and entertainment increases dramatically. In areas where population is falling—as it has in many small towns where farm populations are shrinking—demand for these goods and services falls.

Changes in Supply

The supply of most products is also affected by a number of factors. Most important is the cost of producing products. If the price of natural resources, labor, capital, or entrepreneurship rises, sellers will make less profit and will not be as motivated to produce as many units as they were before the cost of production increased. On the other hand, when production costs fall, the amount producers are willing and able to sell increases.

Technological change also affects supply. A new invention or discovery can allow producers to make something that could not be made before. It could also mean that producers can make more of a product using the same or fewer inputs. The most dramatic example of technological change in the U.S. economy over the past few decades has been in the computer industry. In the 1990s, small computers that people carry to and from work each day were more powerful and many times less expensive than computers that filled entire rooms just 20 to 30 years earlier.

Opportunities to make profits by producing different goods and services also affect the supply of any individual product. Because many producers are willing to move their resources to completely different markets, profits in one part of the economy can affect the supply of almost any other product. For example, if someone running a barbershop decided to sign a contract to provide and operate the machines that clean runways at a large airport, this would decrease the supply of haircutting services and increase the supply of runway sweeping services.

When suppliers believe the price of the good or service they provide is going to rise in the future, they often wait to sell their product, reducing the current supply of the product. On the other hand, if they believe that the price is going to fall in the future, they try to sell more today, increasing the current supply. We see this behavior by large and small sellers. Examples include individuals who are thinking about selling a house or car, corn and wheat farmers deciding whether to sell or store their crops, and corporations selling manufactured products or reserves of natural resources.

Finally, the number of sellers in a market can also affect the level of supply. Generally, markets with a larger number of sellers are more competitive and have a greater supply of the product to be sold than markets with fewer sellers. But in some cases, the technology of producing a product makes it more efficient to produce large quantities at just a few production sites, or perhaps even at just one. For example, it would not make sense to have two or more water and sewage companies running pipes to every house and business in a city. And automobiles can be produced at a much lower cost in large plants than in small ones, because large plants can take greater advantage of assembly-line production methods.

All these different factors can lead to changes in what consumers demand and what producers supply. As a result, on any given day prices for some things will be rising and those for others will be falling. This creates opportunities for some individuals and firms, and problems for others. For example, firms producing goods for which the demand and the price are falling may have to lay off workers or even go out of business. But for the economy as a whole, allowing prices to rise and fall quickly in response to changes in any of the market forces that affect supply and demand offers important advantages. It provides an extremely flexible and decentralized system for getting goods and services produced and delivered to households while responding to a vast number of unpredictable changes.

Creative Destruction

Taking advantage of new opportunities while curtailing production of things that are no longer in demand or no longer competitive was described as the process of *creative destruction* by 20th century Austrian-American economist Joseph Schumpeter. For example, Schumpeter discussed how the United States, Britain, and other market economies helped many new businesses to grow by building systems of canals (such as the Erie Canal) during the mid-19th century. But then the canal systems were replaced or "destroyed" by the railroads, which in turn saw their role diminished with the rise of national systems of highways and airports. The same thing happened in the communications industry in the United States. The Pony Express, which carried mail between Missouri and California in the early 1860s, went out of business with the completion of telegraph lines to California. In the 20th century, the telegraph was replaced by the telephone. Time and time again, one decade's innovation is partially replaced or even destroyed by the next round of technological change.

In the modern world, prices change not only as a result of things that happen in one country, but increasingly because of changes that happen in other countries, too. International change affects production patterns, wages, and jobs in the U.S. economy. Sometimes these changes are triggered by something as simple as weather conditions someplace else in the world that affect the production of grain, coffee, sugar, or other crops. Sometimes it reflects political or financial upheavals in Europe, Asia, or other parts of the world. There have been several examples of such events in the U.S. economy in the 1990s. Higher coffee prices occurred after poor harvests of coffee beans in South America, and U.S. banks lost large sums of money following financial and political crises in places such as Indonesia and Russia.

The ability to respond quickly to an increasingly volatile economic and political environment is, in many ways, one of the greatest strengths of the U.S. economic system. But these changes can result in hardships for some people or even some large segments of the economy. For example, importing clothing produced in other nations has benefited U.S. consumers by keeping clothing prices lower. In addition, it has been profitable for the firms that import and sell this clothing. However, it has also reduced the number of jobs available in clothing manufacturing for U.S. workers.

Many people think the most important general issue facing the U.S. economy today is how to balance the benefits of quickly adapting to changing economic conditions against the costs of abandoning the old ways. It is vital for the economy to adapt quickly to changing conditions and to focus on producing goods and services that will meet the most recent demands of the market place. However, when businesses close because their products no longer meet the

demands of the market, it is important to make retraining or new jobs available to workers who lost their means of making a living.

PRODUCTION OF GOODS AND SERVICES

Before goods and services can be distributed to households and consumed, they must be produced by someone, or by some business or organization. In the United States and other market economies, privately owned firms produce most goods and services using a variety of techniques. One of the most important is specialization, in which different firms make different kinds of products and individual workers perform specific jobs within a company.

Successful firms earn profits for their owners, who accept the risk of losing money if the products the firms try to sell are not purchased by consumers at prices high enough to cover the costs of production. In the modern economy, most firms and workers have found that to be competitive with other firms and workers they must become very good at producing certain kinds of goods and services.

Most businesses in the United States also operate under one of three different legal forms: corporations, partnerships, or sole proprietorships. Each of these forms has certain advantages and disadvantages. Because of that, these three types of business organizations often operate in different kinds of markets. For example, most firms with large amounts of money invested in factories and equipment are organized as corporations.

Specialization and the Division of Labor

In earlier centuries, especially in frontier areas, families in the United States were much more self-sufficient, producing for themselves most of the goods and services they consumed. But as the U.S. population and economy grew, it became easier for people to buy more and more things in the marketplace. Once that happened, people faced a choice they still face today: In terms of time, money, and other things that they could do, is it less expensive to make something themselves or to let someone else produce it and buy it from them?

Over the years, most people and businesses realized that they could make better use of their time and resources by concentrating on one particular kind of work, rather than trying to produce for themselves all the items they want to consume. Most people now work in jobs where they do one kind of work; they are carpenters, bankers, cooks, mechanics, and so forth. Likewise, most businesses produce only certain kinds of goods or services, such as cars, tacos, or gardening services. This feature of production is known as specialization. A high degree of specialization is a key part of the economic system in the United States and all other industrialized economies. When businesses specialize, they focus on providing a particular product or type of product. For instance, some large companies produce only automobiles and trucks, or even special parts of cars and trucks, such as tires.

At almost all businesses, when goods and services are produced, labor is divided among workers, with different employees responsible for completing different tasks. This is known as division of labor. For example, the individual parts of cars and televisions are made by many different workers and then put together in an assembly line. Other well-known examples of this specialization and division of labor are seen in the production of computers and electrical appliances. But even kitchens in large restaurants have different chefs for different items, and

professional workers such as doctors and dentists have also become more specialized during the past century.

Advantages of Specialization

By specializing in what they produce, workers become more expert at a particular part of the production process. As a result, they become more efficient in these jobs, which lowers the costs of production. Specialization also makes it possible to develop tools and machines that help workers do highly specialized tasks. Carpenters use many tools that plumbers and painters do not. Commercial bakeries have much larger ovens and mixers than those used by people who only bake bread and pies once a year. And unlike a household kitchen, a commercial bakery has machines to slice and package bread. All of these tools and machines help workers and businesses produce more efficiently, and lower the cost of producing goods and services.

The advantages of specialization have led to the creation of many very large production facilities in the United States and other industrialized nations. This trend is especially prevalent in the manufacturing sector. For example, many automobile factories produce thousands of cars each day, and some shipyards employ more than 10,000 workers. One open-pit mine in the western United States has dug a crater so large that it can be seen from space.

When the market for a product is very large, and a company can sell enough goods or services in that market to support a very large production facility, it will often choose to produce on a large scale to take advantage of specialization and division of labor. As long as producing more in larger facilities lowers the average costs of production, the producer enjoys what are known as *economies of scale*.

But bigger is not always better, and eventually almost all producers encounter *diseconomies of scale* in which larger plants or production sites become less efficient and more costly to operate. Usually that happens because monitoring and managing increasingly larger production facilities becomes more difficult. That is why most large manufacturers have more than one factory to make their products, instead of one massive facility where they make everything they produce. In recent years, many steel companies have found it more efficient to build and operate smaller steel mills than they once operated.

Specialization and International Trade

Over the past few decades, international trade has led to greater specialization and competition among producers in the United States and throughout the world. By selling worldwide, companies in the United States and in other countries can reach many more customers. Specialization is ultimately limited by the size of the market for a good or service. In other words, larger markets always allow for greater levels of specialization. For example, in small towns with few customers to serve, there is often only one clothing store that carries a small selection of many different kinds of clothing. In large cities with a million or more potential customers, there are much larger clothing stores with many more choices of items and styles, and even some stores that sell only hats, gloves, or some other particular kind of clothing.

International trade is a dramatic way of expanding the size of a firm’s market. In markets where transportation costs are low compared with the selling price of a product, it has become

possible for producers to compete globally to take full advantage of highly specialized production. But international trade also means that businesses must compete more efficiently against firms from all around the world. That competition also makes them try to take advantage of greater specialization and the division of labor.

In many cases, products are produced and sold by firms from two or more countries that have large production and employment levels in the same industry. Often, however, these firms still specialize in the kinds of products they produce. For example, though many small cars and small pickup trucks are made in Japan and sent to the United States, large pickups and four-wheel drive sport utility vehicles are often exported from the United States to Japan and other nations. Similarly, the United States exports large commercial passenger jets to most countries, but imports many small jets from Canada, Brazil, and other nations. While this may seem strange at first glance, it allows greater specialization in production for particular kinds of products.

Transportation costs can also help to explain the pattern of international production and trade. It often makes sense to produce goods close to the markets where they will be sold, or close to where the resources used in the production process are found or made. In recent years, the availability of a skilled and hard-working labor force has become more important to producers in many different industries, so new factories are often located in areas with large numbers of well-trained workers and good schools that provide a future supply of well-educated workers.

Production Patterns: Past, Present, and Future

Several dramatic changes in production patterns occurred in the United States during the 20th century. First, most employment shifted from farming in rural areas to industrial jobs in cities and suburbs. Then, during the second half of the century, production and employment patterns changed again as a result of technological advances, increased levels of world trade, and a rapid increase in the demand for services.

Technological changes in the transportation, communications, and computer industries created entirely new kinds of jobs and businesses, and altered the kinds of skills workers were expected to have in many others. World trade led to increased specialization and competition, as businesses adapted to meet the demands of international competition.

Perhaps the greatest change in the U.S. economy came with the nation’s growing prosperity in the years following World War II (1939-1945). This prosperity resulted in a population with more money to spend on services and leisure activities. More people began dining out at restaurants, taking vacations to far-off locations, and going to movies and other forms of entertainment. As family incomes increased, a wealthier population became more willing to pay others for services.

As a result of these developments, the closing decades of the 20th century saw a dramatic increase in service industries in the United States. In 1940 about 33 percent of U.S. employees worked in manufacturing, and about 49 percent worked in service-producing industries. By the late 1990s, only 26 percent worked in goods-producing industries, and 74 percent worked in service-producing industries. This change was driven by powerful market forces, including technological change and increased levels of world trade, competition, and income.

Some observers worried that this growth of employment in service-producing industries would result in declining living standards for most U.S. workers, but in fact most of this growth has occurred in industries where job skill requirements and wages have risen or at least remained high. That is less surprising when you consider that this employment includes business and repair services, entertainment and recreation occupations, and professional and related services (including health care, education, and legal services). United States consumers and families are, on average, financially better off today than they were 50 or 100 years ago, and they have more leisure time, which is one of the reasons why the demand for services has increased so rapidly.

During the 20th century, businesses and their workers had to adjust to many changes in the kinds of goods and services people demanded. These changes naturally led to changes in where jobs were available, and in what kinds of education, training, and skills employees were expected to have. As the base of employment in the United States has changed from predominantly agriculture to manufacturing to services, individuals, firms, and communities have faced often-difficult adjustments. Many workers lost jobs in traditional occupations and had to seek employment in jobs that required completely different sets of skills. Standards of living declined in some communities whose economies centered on farming or around large factories that shut down. In recent decades, populations have decreased in some states where agriculture provides a significant number of jobs. While high-technology industries in places such as California's Silicon Valley were booming and attracting larger populations, some textile and clothing factories in Southern and Midwest states were closing their doors.