Characteristics of the American Economy

READER’S GUIDE

Terms to Know
- capitalism
- laissez-faire
- free enterprise system
- profit
- profit incentive
- private property
- competition

Reading Objectives
1. What is the role of government in our free enterprise economy?
2. How do freedom of enterprise and freedom of choice apply to the American economy?
3. What roles do private property, the profit incentive, and competition play in the American economy?

Perhaps you wouldn’t buy a soft drink called “Wisdom,” but someone will. That’s one of the characteristics of a market economy—freedom of choice. A seller can choose to make or not make a product, and you can choose to buy it or not.

In this section you’ll learn that a pure market economic system has six major characteristics: (1) little or no government control, (2) freedom of enterprise, (3) freedom of choice, (4) private property, (5) the profit incentive, and (6) competition. These characteristics are interrelated, and all are present in the American economy to varying degrees.
Limited Role of Government

In his book *An Inquiry into the Nature and Causes of the Wealth of Nations*, economist Adam Smith in 1776 described a system in which government has little to do with a nation's economic activity. He said that individuals left on their own would work for their own self-interest. In doing so, they would be guided as if by an "invisible hand" to use resources efficiently and thus achieve the maximum good for society.

Smith's version of the ideal economic system is called *capitalism*, another name for the market system. Pure capitalism has also been called a *laissez-faire* system. The French term means "let [people] do [as they choose]." A pure capitalist system is one in which the government lets people and businesses make their own economic decisions without government constraints. Capitalism as practiced in the United States today would be best defined as an economic system in which private individuals own the factors of production, but decide how to use them within legislated limits. See Figure 2.6.

**Figure 2.6**

Role of Government The government acts as a provider of public services, such as maintaining our national parks. It also acts as protector in the form of food and drug inspection. *List three more examples of how the government is involved in our economy.*

capitalism: economic system in which private individuals own the factors of production

laissez-faire: economic system in which the government minimizes its interference with the economy
Smith’s ideas influenced the Founders of the United States, who limited the role of government mainly to national defense and keeping the peace. Since the 1880s, however, the role of government—federal, state, and local—has increased significantly. Among other things, federal agencies regulate the quality of various foods and drugs, watch over the nation’s money and banking system, inspect workplaces for hazardous conditions, and guard against damage to the environment. The federal government also uses tax revenues to provide social programs such as Social Security and Medicare. State and local governments have expanded their roles in such areas as education, job training, recreation, and care for the elderly.

**Freedom of Enterprise**

As well as capitalist, the American economy is also called a free enterprise system. This term emphasizes that individuals are free to own and control the factors of production. If you go into business for yourself, you may become rich selling your product. However, you may instead lose money, because you—or any entrepreneur—have no guarantee of success.

The government places certain legal restrictions on freedom of enterprise. For instance, just because you know how to fix cars does not mean that you can set up an automobile-repair business in your backyard. Zoning regulations, child-labor laws, hazardous waste disposal rules, and other regulations limit free enterprise to protect you and your neighbors.

**Freedom of Choice**

Freedom of choice is the other side of freedom of enterprise. It means that buyers, not sellers, make the decisions about what should be produced. The success or failure of a good or service in the marketplace depends on individuals freely choosing what they want to buy. If a music company releases a new CD, but few people buy it, the music company most likely will not sign that particular group again. Buyers have signaled that they do not like that group.

Although buyers are free to make choices, the marketplace has become increasingly complex. The government has intervened in various areas of the economy to protect buyers. As shown in Figure 2.7, laws set safety standards for such things as toys, electric appliances, and automobiles. In industries dominated by just a few companies—such as public utilities selling natural gas or electricity—the government regulates the prices they may charge.
Profit Incentive

When a person invests time, know-how, money, and other capital resources in a business, that investment is made with the idea of making a profit. Profit is the money left after all the costs of production have been paid, including wages, rents, interest, and taxes. The desire to make a profit is called the profit incentive, or profit motive. This desire motivates entrepreneurs to establish new businesses and produce new kinds of goods and services.

The risk of failing is also part of the free enterprise system. What happens when profits are not realized—when businesses fail? Losses are a signal to move resources elsewhere. Thus, the interaction of both profits and losses leads to an economy that is more efficient, adaptable to change, and continuously growing.

Private Property

One of the most important characteristics of capitalism is the existence of private property, or property that is held by individuals or groups rather than by the federal, state, or local governments. You as an individual are free to buy whatever you can afford, whether it is land, a business, an automobile, or baseball cards. You can also control how, when, and by whom your property is used. What are called the rights of property, however, are actually the rights of humans to risk investment, own productive assets, learn new ways of producing, and then to enjoy the benefits if these choices result in profits.

The Founders of the United States recognized that such rights must not be violated, because these rights are the invisible engine for creating wealth and prosperity for all. The Constitution guarantees an owner’s right to private property and its use. Thus, in principle, no level of government in the United States can seize or use private property, at least not without paying the owners.
Competition

In a free enterprise system, the lure of profits encourages competition—the rivalry among producers of similar products to win more business by offering lower prices or better quality. Effective competition requires a large number of independent sellers, which means that no single company can noticeably affect the price of a particular product or service. If one company raises its prices, potential customers can simply go to other sellers.

Competition leads to an efficient use of resources. How so? Businesses have to keep prices low enough to attract buyers, yet high enough to make a profit. This forces businesses to keep their costs of production as low as possible.

For competition to exist, barriers to enter and exit from industries must be weak. Businesses must be free to expand into other industries. For the most part, the United States has weak barriers to entry and exit. Yet some industries have tougher barriers to entry. For example, a person cannot become a physician until he or she has received a license from a state government.

SECTION 2 Assessment

Understanding Key Terms
1. Define capitalism, laissez-faire, free enterprise system, profit, profit incentive, private property, competition.

Reviewing Objectives
2. What is the role of government in our free enterprise economy?
3. How do freedom of enterprise and freedom of choice apply to the American economy?
4. Graphic Organizer Create a chart like the one in the next column to summarize the roles that profit incentive, private property, and competition play in the American economy.

Applying Economic Concepts
5. Competition Describe a situation in which a lack of competition caused you to pay more for a good or service.

Critical Thinking Activity
6. Synthesizing Information Shoe Store A offers a pair of high-top sneakers for $48, whereas a competitor—Shoe Store B—offers the same shoe at 25 percent off their regular price of $62. From which store should you buy the shoes? For help in understanding percentages, see page xix in the Economic Handbook.