Chapter Objectives

- Corporate Form Domination in Sales and Profits.
- Principle and Agent Issues.
- Economic Role of Government in the Economy.
- Categories of Government Spending and the Sources of Government Revenues.

Households as Income Receivers

**Functional Distribution of Income-2005**

<table>
<thead>
<tr>
<th>Income by Function Performed</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages &amp; Salaries</td>
<td>71%</td>
</tr>
<tr>
<td>Rents</td>
<td>1%</td>
</tr>
<tr>
<td>Interest</td>
<td>5%</td>
</tr>
<tr>
<td>Proprietor’s Income</td>
<td>9%</td>
</tr>
<tr>
<td>Corporate Profits</td>
<td>14%</td>
</tr>
</tbody>
</table>

Source: Bureau of Economic Analysis
Households as Income Receivers

**Personal Distribution of Income-2004**

<table>
<thead>
<tr>
<th>Income Group (Households)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest 20%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Second 20%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Middle 20%</td>
<td>14.7%</td>
</tr>
<tr>
<td>Fourth 20%</td>
<td>23.2%</td>
</tr>
<tr>
<td>Highest 20%</td>
<td>50.1%</td>
</tr>
</tbody>
</table>

Source: Bureau of the Census

Households as Spenders

**Household Uses of Income-2005**

<table>
<thead>
<tr>
<th>Income Group (Households)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Income Taxes</td>
<td>12%</td>
</tr>
<tr>
<td>Personal Saving</td>
<td>0%</td>
</tr>
<tr>
<td>Consumption</td>
<td>88%</td>
</tr>
</tbody>
</table>

Composition of Consumption

- Services: 59%
- Nondurable Goods: 29%
- Durable Goods: 12%

Source: Bureau of Economic Analysis

The Business Population

- Plant.
- Firm.
- Industry.
- Multiplant Firms.
- Vertically Integrated.
- Conglomerates.
Legal Forms of Business

- Sole Proprietorship
- Partnership
- Corporation

Domestic Output by Business Type

<table>
<thead>
<tr>
<th>Percentage of Firms</th>
<th>Percentage of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporations 20%</td>
<td>Corporations 64%</td>
</tr>
<tr>
<td>Partnerships 8%</td>
<td>Partnerships 11%</td>
</tr>
<tr>
<td>Sole Proprietorships 72%</td>
<td>Sole Proprietorships 5%</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau

Legal Forms of Business

Advantages of Corporations

- Corporate Securities.
  - Stock.
  - Bond.
- Limited Liability.
- Hiring of Specialists.
- Unlimited Lifetime.
- Principal-Agent Problem.

The Public Sector: Government’s Role

- Providing the Legal Structure.
- Maintaining Competition.
  - Monopoly.
  - Regulation.
  - Regulated Monopolies.
  - Antitrust Laws.
  - Sherman Act 1890.
The Public Sector: Government’s Role

- Redistributing Income.
  - Transfer Payments.
  - Market Intervention.
  - Taxation.
- Reallocating Resources.
  - Market Failure.
    - Externalities or Spillovers.
    - Negative or Positive Types.

The Public Sector: Government’s Role

- Correcting for Negative Externalities.
  - Legislation.
  - Specific Taxes.
- Correcting for Positive Externalities.
  - Subsidize Consumers.
  - Subsidize Suppliers.
  - Provide Goods Via Government.

The Public Sector: Government’s Role

- Public Goods and Services.
- Private Goods.
  - Rivalry.
  - Excludability.
- Public Goods.
  - Nonrivalry.
  - Nonexcludability.
  - Free-Rider Problem.
- Quasi-Public Goods.
- The Reallocation Process.
The Public Sector: Government’s Role

- Promoting Stability.
  - Unemployment.
  - Inflation.
- Government’s Role: A Qualification.
  - Political Context.
  - Overregulation.
  - Underregulation.
  - Benefits and Costs.
  - Not Perfectly Carried Out.

The Circular Flow Revisited

Government Finance

- Government Purchases
- Government Transfers
Federal Finance

Federal Expenditures-2005

Four Stand-Out Areas of Spending

- Pensions & Income Security: 35%
- National Defense: 20%
- Health: 17%
- Interest on the Public Debt: 7%

Source: U.S. Office of Management and Budget

Federal Finance

Federal Tax Revenues-2005

- Progressive Tax Rates.
  - Brackets of Income.
- Marginal Tax Rate.
- Average Tax Rate.
Federal Finance

Federal Tax Revenues-2005
Basic Revenue Sources

- Personal Income Tax: 43%
- Payroll Taxes: 37%
- Corporate Income Taxes: 13%
- Excise Taxes: 3%
- All Other: 4%

Source: U.S. Office of Management and Budget

State and Local Finance

State Finances
- Primary Revenues:
  - Sales & Excise Taxes - 48%
  - Personal Income Taxes - 34%
  - Corporate Income Taxes & License Fees: Most of Balance
- Primary Expenditures:
  - Education - 35%
  - Public Welfare - 28%
  - Health & Hospitals - 7%
  - Highways - 7%
  - Public Safety - 4%
  - Other - 19%

State and Local Finance

Local Finances
- Primary Revenues:
  - Property Taxes - 73%
  - Sales & Excise Taxes - 17%
- Primary Expenditures:
  - Education - 44%
  - Welfare, Health & Hospitals - 12%
  - Public Safety - 11%
  - Housing, Parks, & Sewers - 8%
  - Streets & Highways - 5%
Financing Social Security

• Demographic Changes.
• Severe Long-Run Shortfall in Social Security Funding.
• Annual Pay-as-You-Go Plan.
• Impact of Baby Boomer Retirements.
• 2017 Revenues Less Than Payments – Trust Fund Withdrawals.
• Trust Fund Exhausted in 2041.
• Possible Benefit Reductions and Tax Revenue Increases.

Financing Social Security

• Possible Solutions.
  – Stock & Bond Investments.
  – Payroll Tax Increases.
  – Individually Directed Accounts for Annuity Incomes Owned by Government.
  – Half of Payroll Deduction in Privately Owned and Managed Accounts – Phased in Over Time.
• Consensus Solution to be Very Difficult.

Key Terms Page

• Functional distribution of income
• Personal distribution of income
• Durable goods
• Nondurable goods
• Services
• Plant
• Firm
• Industry
• Sole proprietorship
• Partnership
• Corporation
• Stock
• Bond
• Limited liability
• Principal-agent problem
• Monopoly
• Externality
• Negative externalities
• Positive externalities
• Public goods
• Free-rider problem
• Quasi-public goods
• Government purchases
• Transfer payments
• Personal income tax
• Marginal tax rate
• Average tax rate
• Payroll taxes
• Corporate income tax
• Sales and excise taxes
• Property taxes
Next Chapter Preview...

The United States in the Global Economy

Chapter 5