The Role of Government

The circular flow model is a simple illustration of a market economy governed entirely by prices. However, no society relies exclusively on markets to deal with the basic economic problem of scarcity. In command economies the government takes a leading role, while in market economies the role of government is more limited.

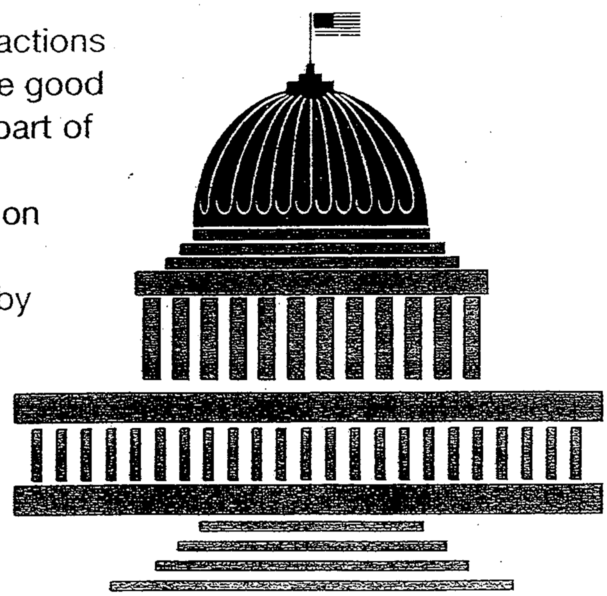
Different Roles of Government: In the United States economy, government performs the following roles:

- ***Provides a legal Framework:*** Without an effective legal framework the price system cannot operate effectively. Government provides a legal framework when it enforces private contracts, defines private property rights, establishes uniform weights and measures, and establishes and enforces laws and rules governing marketplace activity.

- ***Ensures Competition:*** The market (price) system operates effectively when there are many buyers and sellers competing in the marketplace. The government uses its powers to ensure that one seller **(monopoly)** or a few sellers **(oligopoly)** do not control a specific area of the economy to the detriment of consumers. The government also establishes public service commissions to regulate **natural monopolies** such as utility companies.

- ***Provides Public Goods:*** Certain goods and services, known as **public goods**, will be provided in less than the desired amount if production is left to the market system alone. The government, therefore, provides these goods and services. Examples include national defense, roads, flood control projects, and lighthouses.

- ***Controls Externalities:*** Certain market transactions result in **externalities**, or spillovers, that cause good or bad effects on others who are not directly part of the transactions. Pollution is an example of a **negative spillover**. Since polluters can pass on the effects (costs) of pollution to others, the government attempts to correct the situation by prohibiting or regulating certain production activities. Education is commonly cited as a **positive spillover**. Since individuals in society other than the direct recipients and providers of the education also benefit, the government uses taxes to provide public education.



- ***Redistributes Income:*** The government uses tax revenues to provide a social "safety net" for individuals with little or no income. Examples include Medicaid, food stamps, public housing, Aid to Families with Dependent Children (AFDC), earned income tax credit (EITC), and free and reduced school lunches.

- ***Stabilizes the Economy:*** Our economy is characterized by **business cycles** that create hardships for many people.[5] In "downturns" **(recessions)** there is little or no economic growth, often resulting in significant unemployment. In "upturns" there is frequently more inflation.[6] The government uses **fiscal policy** (taxing and spending decisions), and the Federal Reserve Banking System uses **monetary policy** (money supply decisions) to help keep the economy as stable as possible. When an economy experiences rising inflation and increasing unemployment simultaneously, this is known as **stagflation**.

The Role of Government in the United States Economy

1. Provides a Legal Framework
2. Ensures Competition
3. Provides Public Goods
4. Controls Externalities (Spillovers)
5. Redistributes Income
6. Stabilizes the Economy

The Growing Role of Government: The role of government in our economy has grown. In 1929, national, state, and local government expenditures accounted for about 10 percent of our national output, or **gross domestic product (GDP)**. By 2003 these expenditures (including **transfer payments** such as Social Security and welfare payments) were approximately 33 percent of GDP. There is much controversy about the growing role of government since the services and transfer payments provided by government must ultimately be paid for by **taxes** taken from individuals.

Not everyone agrees that government should assume all of the roles identified above. Some believe that government ultimately does more harm than good when it redistributes income and when it attempts to stabilize the economy. In general, they contend that the growth of government has resulted in a great loss of individual liberty.

5. Many economists believe that pronounced business cycles are a natural and inevitable characteristic of a market economy. However, some economists believe business cycles are the result of non-market factors, especially government interference in the financial capital markets and the structure of the banking system.

6. Economists generally define inflation as a persistent increase in the prices of most or all goods and services over a period of time. Over long periods, inflation is caused by an increase in the supply of money that is greater than the increase in the output of goods and services.