Principles of the US Economic System

Freedom of Enterprise

The freedom people in the system enjoy to enter any legal business and conduct it as they see fit

Limitations

Public utilities| gas, electricity

Usually the only source for certain products

Gov’t ends up regulating what they provide/cost

Gov’t require licensing, supervision, and regulation

Despite limitations, people still have freedom to organize and operate as they choose

Private Property

Right to private property| allowing individuals to own property and use it in any lawful manner

Right of individuals to own the means of production| factories, farms, stores (capitalism)

In some command economies, gov’t owns means of production

Rights are subject to limitations

Gov’t can tax those who own/inherit property

Eminent domain| gives gov’t power to seize property it intends to use for public purpose

Requires that gov’t pay a fair price for the property it seizes

Profit Motive

Profits = what remains after the expense of doing business is subtracted from a firm’s income

Are uncertain

If business is poor = little profit; business is successful = don’t know how much can earn

To improve profits

Keep costs down, while increasing income

Entrepreneurs rely on profits to keep their operation on track

Profit Motive| willingness to risk financial loss by organizing and launching a business enterprise

Consumer Sovereignty

Consumers are free to choose which goods and services they will buy/reject

Consumer sovereignty| the need to give consumers what they want

Consumers “vote” buy buying and “vote” against by not buying products

Most successful businesses can “anticipate the market” (determine what consumers want) or

can successfully create a demand for their products through advertising

Can be limited by gov’t policy

If gov’t needs titanium, less of it will be available for consumer products

Can be limited when there are but two or three producers

Light bulbs are manufactured by three diff producers; can choose size, shape, wattage, etc.

Competition| rivalry among sellers in the same field for consumer dollars

Pressures business firms to constantly try to

Provide the best services

Create the best products at the lowest possible prices

Way for companies to appeal to consumer sovereignty = earn greater profits

Specialization and the Economy

People need to rely on others to provide GaS for them

Specialization| workers that perform one specialized task and depend on others to satisfy needs

Ex: farmers produce food for other people to eat

Advantages

Workers are able to produce more because they become highly skilled in their areas

Workers become more efficient at their specialized tasks, as well as companies

Encourages efficient use of capital

Promotes innovation| new way of doing things

Only possible where markets are large enough to support them (limited by the extent of the market)

The Circular Flow of Economic Activity

Circular flow

Fig1. People get wages → pays businesses for goods → business pays employees → repeat

Fig2. People provide services → businesses produce GaS → businesses give GaS → repeat

Adding gov’t to our model

Fig3. Consumer spending → businesses pay for services → repeat

Fig4. Consumer taxes → gov’t gives wages, interest, etc. → repeat

Gross Domestic Product

GDP| total value of the GaS produced in a single year

Consumer spending + investment + gov’t spending = GDP (C + I + G = GDP

The US Economy is a Market System

Dollars as votes in a market economy

Circular flowcharts show the markets involved in money transactions

Markets are polling places where money and buying of products are votes

How the price-directed market system works

Decisions to supply GaS that consumers want are made by people in their own interest

Market economy| economic decisions made by the nation’s businesses and those who buy the stuff

Role of Prices

Price-directed economy| prices drive how consumers and businesses deal with GaS

*Prices affect WHAT GaS will be produced*

Fundamental economic question of WHAT GaS are produced in a market economy

is decided by what consumers are willing and able to pay for things they want

*Prices affect HOW GaS are produced*

How to combine factors of production depends on estimates as to what will become lowest cost

*Prices affect WHO will receive GaS*

Size of an individual’s income determines the amount of GaS that person can buy

Rents in poorer sections of town are lower than in more prosperous areas

Richer people less likely to live in poorer areas

Landlords in poorer areas need to lower rent to find tenants

Evaluation of the Market System

Advantages

The market system is the most efficient of all economic systems

Producers compete for consumers, consumers prefer best products at lowest prices = improve efficiency = improved products and services and reduced costs = profit

The market system is more sensitive to consumer demand than other economic systems

Businesses do everything they can do to produce/offer things consumers want

Disadvantages

The market system does not provide all of the GaS needed by society

Even though private buildings are made, private individuals are unlikely to share/pay for the construction of the thousands of needed public buildings (i.e. schools, hospitals, roads)

People are often willing to buy products only if they acquire the right exclusive use of said product

Food and clothes are private GaS

Streets, police protection, public health, etc. are public GaS

The market system does not adequately provide for the needs of all the people

System rewards those who are efficient and productive citizens, but not provide adequately for all

The market system is likely to experience periods of expansion and contraction of business activity

Gov’t plays a part in helping raise employment rates (ex: Great Depression compared to now)

The need for gov’t involvement to solve such a problem = weakness

The market system cannot account for many harmful costs of doing business

Ex: coal-powered manufacturing facility that pollutes the atmosphere

Economists see coal and air as resources

Coal is privately owned| must be paid for by those who use it

Air is “publicly” owned

Coal is an internal cost| a cost that is part of the expense of doing business

Air is an externality/external cost| business costs paid for by society as a whole

No penalty for polluting the air, the facility has no economic reason for changing its policies

Our Nation’s Economic Goals

Economic Freedom

Right to spend or save money as one wishes

Own the goods one has purchased

Right of business people to own property and make a profit

Limited by rules of law

Even though people can run their own firms doesn’t mean they can produce stuff that endangers people

Economic Justice

Most agree on equal economic opportunity regardless of nationality, age, sex, etc.

Not everyone agrees on what constitutes as “equal economic opportunity”

Economic Stability

Period of economic stability = changes in the level of prices, employment, and business activity are modest

Prices are affordable, jobs are plentiful

Economic decline| business activity falls off, workers lose jobs, resources lie idle

Can become a depression, milder version is a recession

Economic inflation| rise in prices, cannot buy as much GaS

Especially harsh on those with fixed incomes like pensions

Employment Act of 1946| gov’t responsible for employment, production, and purchasing power

Economic Efficiency

Best use of resources to provide the greatest quantity of GaS that citizens want

Economic Security

Setting aside earnings in the form of savings, insurance, etc. for times of illness/unemployment at old age

Many firms and labor unions provide their employees and members with insurance and retirement plans

Gov’t have established programs to offset the risk resulting from loss of income

Social security, unemployment insurance, welfare, savings deposit insurance

Economic Growth

Economic growth| an increasing output of GaS

Unlimited economic growth = increased production = increased pollution and the loss of natural resources

The U.S. economic system of capitalism rests on the principles of free enterprise, private property, the profit motive, consumer sovereignty, and competition. In modern economies, people and businesses specialize. Individuals and businesses must rely on the labors of others to supply them with most of their needs. The circular flow model describes the stream of funds, goods, and services constantly passing back and forth among consumers, businesses, and government. In our market economy, prices determine WHAT goods and services will be produced, HOW they are produced, and WHO will receive these goods and services. The market system has many advantages, including efficiency and sensitivity to consumer demands. It does not, however, provide all of the goods and services needed by society. Moreover, it does not ensure stability of production and employment.