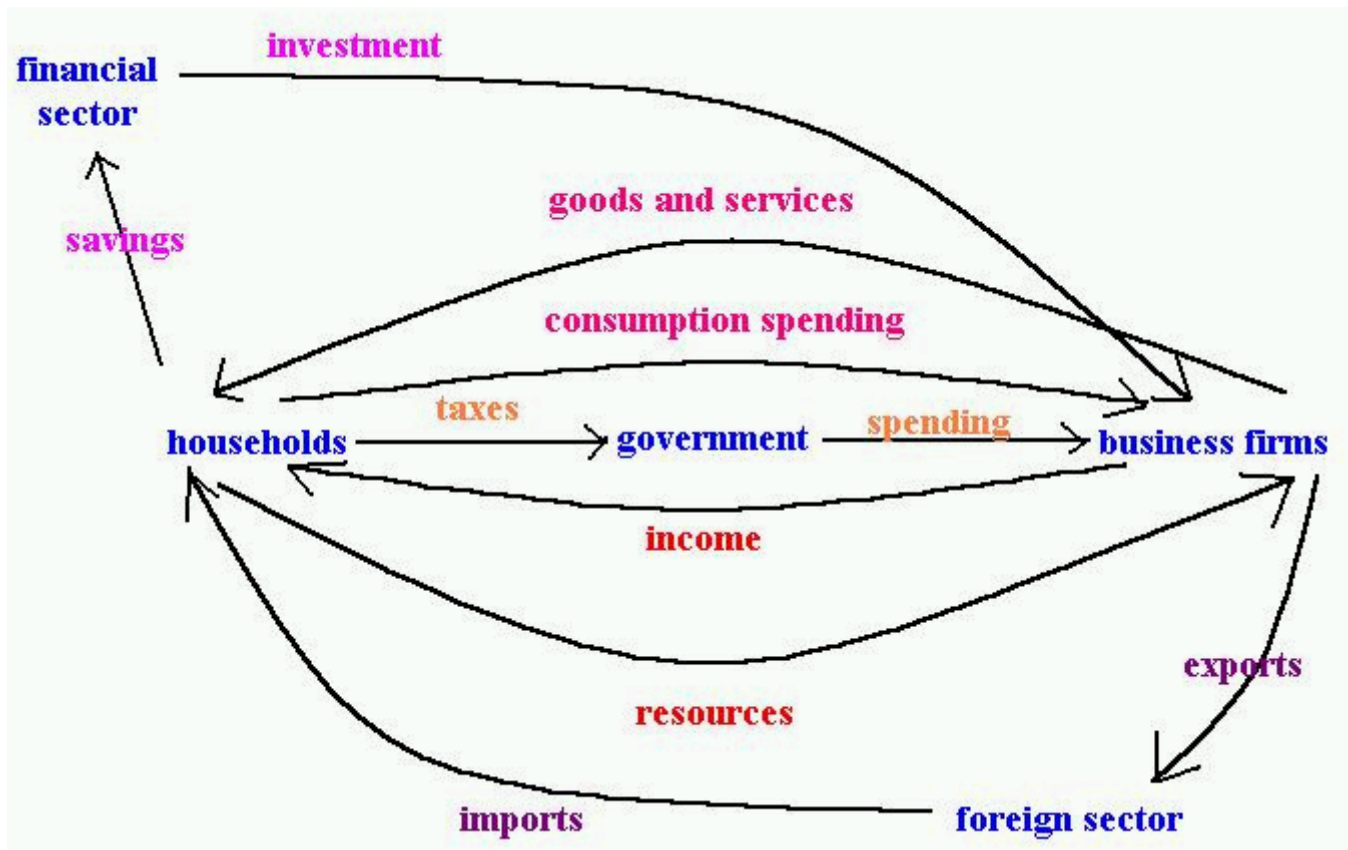


Lecture 3: A Tour of the Economy

circular flow
 households
 business firms
 government
 financial sector
 international sector

Circular Flow



The circular flow diagram shows the interactions among the various actors and sectors of the economy. An economic actor is any entity that makes an economic decision.

Households

Households have two important roles in the economy:

1. households own the economic resources (land, labor, and capital) and supply them to business firms in return for income (rent, wages, and interest)
 2. households spend part of this income on the goods and services produced by firms
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Business Firms

Businesses produce goods and services using the economic resources supplied by households. There are approximately 24 million businesses in the U.S. The most numerous are **proprietorships**. A proprietorship is owned by one person who receives all the profits and is responsible for all the debts incurred by the business (unlimited liability). The advantages of a proprietorship are (1) the owner has complete control of the business, (2) there is little legal complication involved in starting a proprietorship, and (3) the profits of the business are part of the income of the proprietor and, therefore, are taxed under the personal income tax. The disadvantages of a proprietorship are (1) the difficulty in raising funds for the business and (2) the proprietor's unlimited liability for the debts of the business.

A The second form of business is the **partnership**. A partnership consists of two or more owners who share the profits and responsibility for the firm's losses. A partnership has the same tax advantage as a proprietorship: the profits of the business are treated as the personal income of the partners. More owners also gives partnerships access to a larger source of funds for the business. On the disadvantage side partnerships are legally complicated: whenever there is a change in ownership the partnership is automatically dissolved. Also, the partners have unlimited liability for the debts of the business.

Most large businesses are organized as **corporations**. A corporation is a legal entity owned by shareholders whose liability for the firm's debts is limited to the value of the stock they own (limited liability). One disadvantage faced by a corporation is that it is subject to double taxation: dividends paid to shareholders are taxed once under the corporate income tax and then again under the personal income tax. A second disadvantage is the separation of ownership from control. Those managing the corporation may not act in the best interests of the shareholders.

Government

The government taxes, spends, and regulates. All levels of government together purchase about 20% of all the goods and services produced each year.

Financial Sector

The financial sector acts as an intermediary between savers and investors. The financial sector includes financial markets such as stock and bond markets and financial intermediaries like banks, mutual funds, and insurance companies.

International Sector

The American economy has extensive interactions with the rest of the world. Trade in goods, services, and income is one such interaction. Exports are products made in this country and sold abroad; imports are foreign made products purchased by Americans.

