The Market System and the Circular Flow

From:

Book 1: Chapter 2

Economic Systems

- **Laissez-Faire Capitalism**
  - The term “laissez-faire” is the French for “let it be,”
  - In laissez-faire capitalism —or “pure capitalism”—the government’s role would be limited to protecting private property from theft and aggression and establishing a legal environment in which contracts would be enforced and people could interact in markets to buy and sell goods, services, and resources.

Economic Systems (Cont'd)

- **The Command System**
  - The polar opposite of laissez-faire capitalism
  - government owns most property resources
  - economic decision making is set by a central planning board created and enforced by the government.
  - also known as **socialism** or **communism** .

Economic Systems (Cont'd)

- **The Market System**
  - also known as **capitalism** or the **mixed economy**.
  - no single individual or organization or government is responsible for solving the economic problems in a market economy.
  - characterized by a mixture of centralized initiatives and decentralized actions
  - The precise mixture varies from country to country
  - Not Chaos, but Economic Order

Characteristics of the Market System

1. Private Property

- private individuals and firms, not the government, own most of the property resources (land and capital).
- **Consequences of property rights:**
  - **mutually agreeable** economic transactions take place
  - encourage investment, innovation, exchange, maintenance of property, and economic growth
  - facilitate exchange
  - encourage owners to maintain or improve their property so as to preserve or increase its value.
- extend to intellectual property through patents, copyrights, and trademarks.

Characteristics of the Market System

2. Freedom of Enterprise and Choice

- **Freedom of enterprise** ensures that entrepreneurs and private businesses are free to obtain and use economic resources to produce their choice of goods and services and to sell them in their chosen markets.
- **Freedom of choice** enables
  - owners to employ or dispose of their property and money as they see fit.
  - workers to try to enter any line of work for which they are qualified.
  - consumers are free to buy the goods and services that best satisfy their wants and that their budgets allow.

Characteristics of the Market System

3. Self-Interest

- motivating force of the various economic units as they express their free choices.
- Self-interest simply means that each economic unit tries to achieve its own particular goal, which usually requires delivering something of value to others.
- Entrepreneur, Property owner, Worker, Consumer

Characteristics of the Market System

4. Competition

- competition requires:
  - Two or more buyers and two or more sellers acting independently in a particular product or resource market.
  - Freedom of sellers and buyers to enter or leave markets, on the basis of their economic self-interest.
- no single will dictate the price – limit the potential abuse of power
- It is the basic regulatory force in the market system.

Characteristics of the Market System

5. Markets and Prices

- market is an institution or mechanism that brings buyers (“demanders”) and sellers (“suppliers”) into contact.
- A market system conveys the decisions made by buyers and sellers of products and resources.
- Just as competition is the regulatory mechanism of the market system, the market system itself is the organizing and coordinating mechanism.

Characteristics of the Market System

6. Technology and Capital Goods

- competition, freedom of choice, self-interest, and personal reward provide the opportunity and motivation for technological advance.
- The monetary rewards for new products or production techniques accrue directly to the innovator.
- Advanced technology and capital goods are important for efficiency.
  - More efficient production means much more abundant output.

Characteristics of the Market System

7. Specialization

- using the resources of an individual, firm, region, or nation to produce one or a few goods or services rather than the entire range of goods and services.
  - Those goods and services are then exchanged for a full range of desired products.
- Society learned long ago that self-sufficiency breeds inefficiency.
- Human Specialization: "**Division of Labor**"
- Geographic Specialization

Characteristics of the Market System

8. Use of Money

- Money performs several functions, but first and foremost it is a **medium of exchange**. It makes trade easier.
- Exchange can, and sometimes does, occur through **barter** but it requires a **coincidence of wants**
- To serve as money, an item needs to pass **only one test**: It must be generally acceptable to sellers in exchange for their goods and services.
- Money is socially defined; whatever society accepts as a medium of exchange is money.

Characteristics of the Market System

9. Active, but Limited, Government

- An active, but limited, government is the final characteristic of market systems in modern advanced industrial economies.

Five Fundamental Questions

- The key features of the market system help explain how market economies respond to five fundamental questions:
  - What goods and services will be produced?
  - How will the goods and services be produced?
  - Who will get the goods and services?
  - How will the system accommodate change?
  - How will the system promote progress?

What goods and services will be produced?

- The answer: It is determined by the dollar votes of consumers in their daily purchase decisions.
  - Horses and horseshoes VS automobile and tires.
- Consumers register their preferences in the market; producers and resource suppliers, prompted by their own self-interest, respond appropriately.

How will the goods and services be produced?

- The answer: In combinations and ways that minimize the cost per unit of output.
  - Because inefficiency drives up costs and lowers profits.
- Firm make efforts to minimize production costs.
  - These efforts intensified due to competition
- Simply stated: Competition eliminates high-cost producers.

Example (pg. 34)

TABLE 2.1 Three Techniques for Producing $15 Worth of Bar Soap

Resource	Price per Unit of Resource	Units of Resource					
		Technique 1		Technique 2		Technique 3	
		Units	Cost	Units	Cost	Units	Cost
Labor	$2	4	$ 8	2	$ 4	1	$ 2
Land	1	1	1	3	3	4	4
Capital	3	1	3	1	3	2	6
Entrepreneurial ability	3	1	3	1	3	1	3
Total cost of $15 worth of bar soap			$15		$13		$15

Who will get the goods and services?

- Consumers on the basis of their **ability** and **willingness** to pay its existing market price.
- The ability depends on the amount of **income**
- The amount of income depends on:
  1. the quantities of the property and human resources they supply and
  2. the prices those resources command in the resource market.
- **Resource prices** (wages, interest, rent, profit) are crucial in determining the size of each person's income and therefore each person's ability to buy part of the economy's output.

How will the system accommodate change?

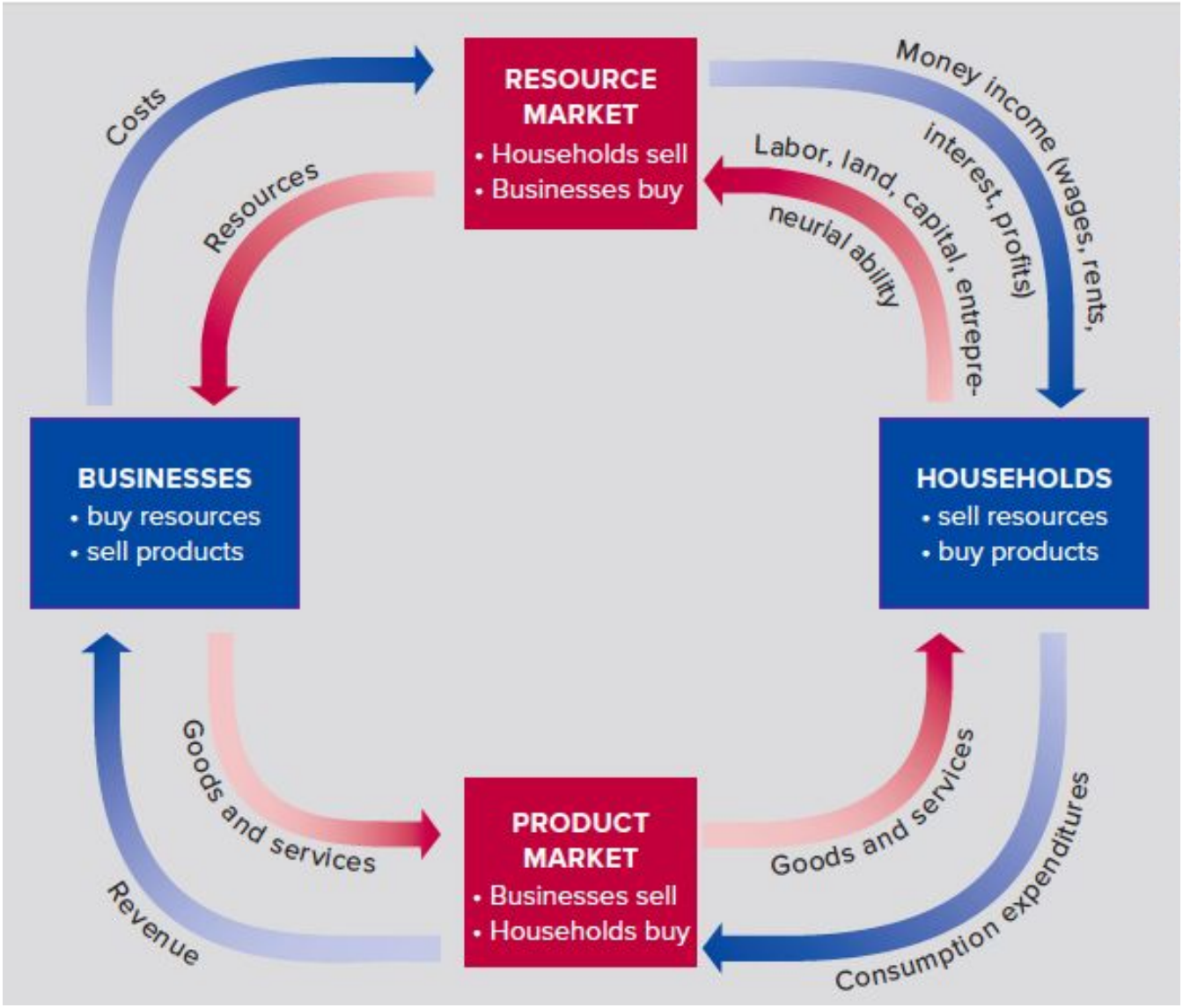
- Through directing or guiding function of prices and profits
- Market systems are dynamic:
  - Consumer preferences, technologies, and resource supplies all change.
- The market system is a gigantic communications system.
  - Through changes in prices and profits, it communicates changes
  - Consumer tastes direct the expansion of some industries and the contraction of others.
  - Those adjustments are conveyed to the resource market.

How will the system promote progress?

- Society desires economic growth (greater output) and higher standards of living (greater output per person)
- **technological improvements** and **capital accumulation**, contribute to a higher standard of living for society

- <u>Technological Advance</u>
  - The market system provides a strong incentive for it through **Creative Destruction**
- <u>Capital Accumulation</u>
  - Most technological advances require additional capital goods.

The Circular Flow Model (Fig. 2.2)



The Circular Flow Model

- The model illustrates how resources flow from households to businesses and how payments for those resources flow from businesses to households.

Figure 2.2 represents:

- Households
- Businesses
  - Sole proprietorship
  - Partnership
  - Corporation
- Product Market
- Resource Market

PROBLEMS

1. Table 2.1 contains information on three techniques for producing $15 worth of bar soap. Assume that we said "$15 worth of bar soap" because soap costs $3 per bar and all three techniques produce 5 bars of soap ($15 = $3 per bar × 5 bars). So you know each technique produces 5 bars of soap. LO2.3
   a. What technique will you want to use if the price of a bar of soap falls to $2.75? What if the price of a bar of soap rises to $4? To $5?
   b. How many bars of soap will you want to produce if the price of a bar of soap falls to $2.00?
   c. Suppose that the price of soap is again $3 per bar but that the prices of all four resources are now $1 per unit. Which is now the least-profitable technique?
   d. If the resource prices return to their original levels (the ones shown in the table), but a new technique is invented that can produce 3 bars of soap (yes, 3 bars, not 5 bars!), using 1 unit of each of the four resources, will firms prefer the new technique?