

THE MARKET SYSTEM AND CIRCULAR FLOW

- I. Economic Systems: Institutional arrangements and coordinating mechanism to respond to economic problems, challenges and opportunities
 - a. The Command System: Socialism or Communism
 - i. Government owns most property resources and economic decision-making occurs through a central economic plan
 1. Division of output between capital and consumer goods is centrally decided.
 2. There is some private ownership even in command economies
 3. North Korea and Cuba are the last remaining examples: look at global snapshot 2.1 on page 36
 - b. The Market System: Capitalism
 - i. Private ownership of resources and use of Markets and Prices to coordinate and direct economic activity.
 1. Self-interest
 2. Individuals and businesses achieve economic goals through work, consumption and production
 3. Markets are places where buyers and sellers come together. Result is competition among independent buyers and sellers.
 4. Laissez-faire capitalism: let it be
 5. Government does play critical role in capitalism: protection
- II. Characteristics of the Market System

- a. Private Property: private individuals and firms own most of the property resources (land and capital)
 - i. Right of property plus freedom to negotiate binding contracts enable individuals and firms to obtain, own, use, and dispose of property resources as they see fit.
 - ii. Encourage innovation, investment, exchange, maintenance of property, and economic growth.
 - iii. Includes intellectual property through patents, copyrights and trademarks.
 - iv. Facilitate exchange.
- b. Freedom of Enterprise and Choice
 - i. Freedom of Enterprise means that individuals and firms can obtain and use economic resources to produce goods and services.
 - ii. Freedom of Choice allows individuals and firms to obtain, own, use and dispose of property and money as they see fit.
- c. Self-Interest: motivating force of economic units and they express their free choice
 - i. Each economic unit strives to achieve their specific economic goal.
- d. Competition: freedom of choice in pursuit of a monetary return
 - i. Independent buyers and sellers operating in a product or resource market
 - ii. Freedom of buyers and sellers to enter or exit markets based on economic self-interest
 - iii. Diffuses economic power within businesses and households

- iv. Allows producers to enter or exit an industry or market
- v. Diffusion of economic power limits abuse of that power
 - 1. Regulatory force in marketplace
- e. Markets and Prices: key components of the market system
 - i. Market is an institution or mechanism that brings buyers and sellers together.
 - ii. Through this mechanism, societies decide what the economy should produce, how production can be organized efficiently and how they are to be distributed.
- f. Technology and Capital Goods: market system promotes extensive use and rapid development for economic growth
- g. Specialization: Use of resources to produce a few goods and services
 - i. Self-sufficiency breeds inefficiency
 - ii. Division of Labor: human specialization
 - 1. Makes use of differences in ability
 - 2. Fosters learning by doing: develop key skills: lawyer
 - 3. Saves time: not shifting from one job to another
 - 4. Geographic specialization: no oranges in Nebraska
- h. Use of Money: medium of exchange
 - i. Allows for complex transactions: cannot barter across many different transactions
 - ii. Barter is swapping of goods or services
 - iii. Money is convenient social invention to facilitate exchange of goods and services: socially defined
- i. Active, but Limited Government

- III. Four Fundamental Questions: What, How, Who, Promote Progress
 - a. What Will Be Produced?
 - i. TR is greater than TC (wage and salary to labor, interest for land and rent and also payments to entrepreneur for organizing and combining economic resources to produce a good or service)
 - ii. If TC is greater than TR; ability to exit market or industry
 - iii. Consumer Sovereignty is crucial in determining types of goods and services produced
 - iv. Dollar votes are votes consumers and entrepreneurs cast to determine what goods and services should be produced.
 - b. How Will Good and Services Be Produced?
 - i. Combination of resources and technologies that minimize cost per unit of output. Maximizes profit potential.
 - c. Who Will Get Output
 - i. Ability and willingness of consumers to pay existing market price.
 - ii. Depends on amount of income consumers have, along with price of various goods and services in the marketplace.
 - d. How Will the System Promote Progress
 - i. Technological Advance: market provides incentive for superior goods to supplant inferior ones
 - ii. Creative destruction: typewriters, LPs
 - iii. Capital Accumulation: dollar voting for capital goods: entrepreneurs and businesses
- IV. The Circular Flow Model: economic circle of life

- a. Review figure 2.2 on page 148 in detail
 - b. Resource Market: place where resources or the service of resource suppliers are bought and sold:
 - i. Households own all economic resources
 - ii. Funds paid to households are costs to the businesses but are flows of wages, interest, rent and profit income to households
 - c. Product Market: place where goods and services produced by businesses are bought and sold
 - i. Flow of money from households from their limited income
 - ii. Compare flow of money from households in product market to flow of money from businesses in resource market to determine profitability and whether or not that particular good or service should be produced.
 - d. Counterclockwise real flow of economic resources versus clockwise money flow of income and consumption expenditures
- V. Facts about U.S. Businesses
- a. Sole Proprietorship is 72% of firms, but 5% of sales revenues
 - b. Partnership is 8% of firms and 11% of sales revenues
 - c. Corporation is 20% of firms, but 84% of sales revenues
 - i. Legal creation that can acquire resources, own assets, produce and sell products and services, incur debts, extend credit, sue and be sued, and perform functions of enterprise

- ii. Sells stock which is ownership in the corporation
 - iii. Legal and financial responsibility limited to loss of value of shares
- VI. Facts about U.S. Households
 - a. 114 MM households- 1 or more persons occupying a housing unit
 - i. Suppliers of all economic resources
 - ii. Major spenders in the economy
 - iii. Review figures 2.4a and 2.4b on page 52