

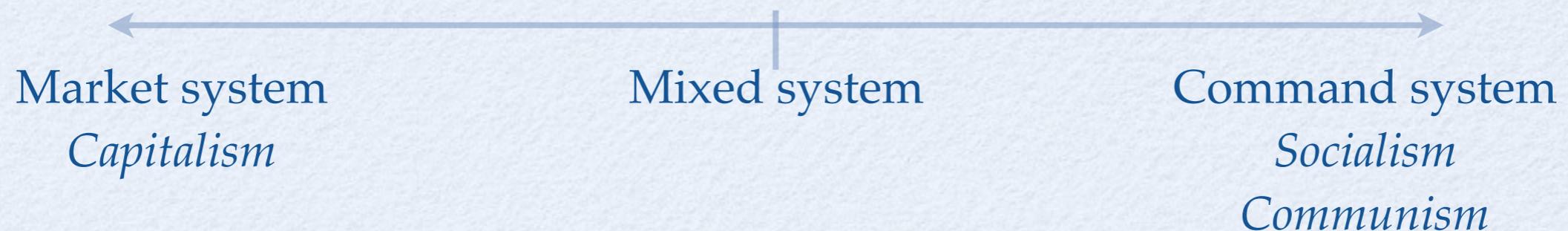
# CHAPTERS 2 & 16

# CHAPTER 2 & 16 - THE MARKET SYSTEM AND THE CIRCULAR FLOW

## Economic Systems

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**Economic systems** differ as to (1) who owns the factors of production and (2) the method used to motivate, coordinate and direct economic activity.



**Command system** - government owns most property resources and economic decision making occurs through a **central economic plan**. A central planning board makes nearly all of the decisions. The division of output between capital and consumer goods is centrally decided.

**Market system** - **private ownership** of resources and the **use of markets** and prices to coordinate and direct economic activity. **Self interest** is prevailing. In pure capitalism, the government's role is very limited - *laissez faire* "let it be" - do not let the government interfere with the economy.

# Characteristics of the Market System

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- **Private property** - investment, innovation, exchange, maintenance of property, economic growth
- **Freedom of enterprise and choice** - obtain and use economic resources
- **Self interest** - the motivating force
- **Competition** - diffuses economic power among the units
- **Markets and prices** - brings buyers and sellers together who through demand and supply establish prices in the market place
- **Technology and capital goods** - the market system encourages the development of capital goods
- **Specialization** - most efficient uses of resources, division of labor, geographic spec
- **Use of money** - medium of exchange - legal tender
- **Active but limited government** - *laissez-faire*

# Five fundamental Questions

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1. **What will be produced?** - Consumer sovereignty - “dollar votes”, entry ( $TR > TC$ ) and exit ( $TR < TC$ ) of firms, resource supplies are determined by S & D
2. **How will the goods and services be produced?** - least cost production with most efficient uses of resources
3. **Who will get the output?** - whoever pays the price in the marketplace
4. **How will the system accommodate change?** - consumer preferences, technology, supply of resources, prices and profits
5. **How will the system promote progress?** - technological advance but some industries get destroyed typewriter vs word processors

# The Invisible Hand

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1776 - *Adam Smith* - **The Wealth of Nations**

**Change** in society's wants  $\Rightarrow$  the competitive market system guided by **self interest** will facilitate change. In order to make higher profits, businesses negotiate change as they make higher profits with **least cost methods** and therefore, **greater allocation of resources**. Hence, they further the best interest of society. **The market system creates a unity between private interests and social interests.**

Virtues of the market system

- Efficiency - efficient uses of resources
- Incentives - skill acquisition, hard work, innovation
- Freedom - personal freedom

# The Demise of the Command System

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## The Coordination Problem

- Central planning coordination is overwhelming
- As the economy grew the problem became even greater - too many products
- Success indicator is quantitative production quota not profit motive

## The Incentive Problem

- As long as the production quota was met despite shortages / overproduction there was no incentive to change production
- Lack of entrepreneurship - no profit motive

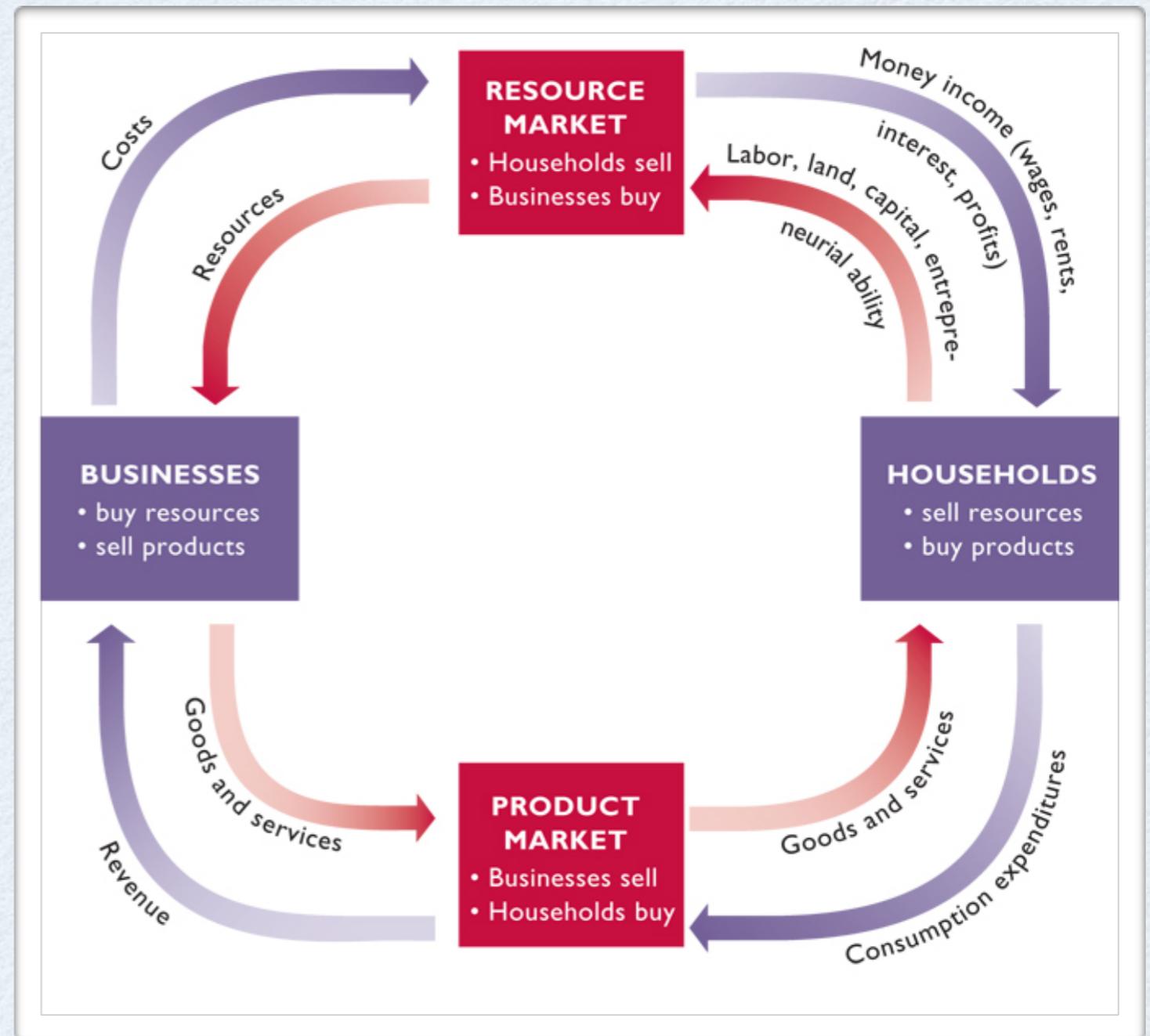


	North Korea	South Korea
GDP	\$40 billion*	\$1.2 trillion*
GDP per capita	\$1,800*	\$24,500*
Exports	\$1.3 billion	\$326 billion
Imports	\$2.7 billion	\$309.3 billion
Agriculture as % of GDP	30 percent	3 percent

\*Based on purchasing power equivalencies to the U.S. dollar.  
Source: CIA World Fact Book, 2008, [www.cia.gov](http://www.cia.gov).

## The Circular Flow Model

- Businesses and Households
- Resource and Product Market

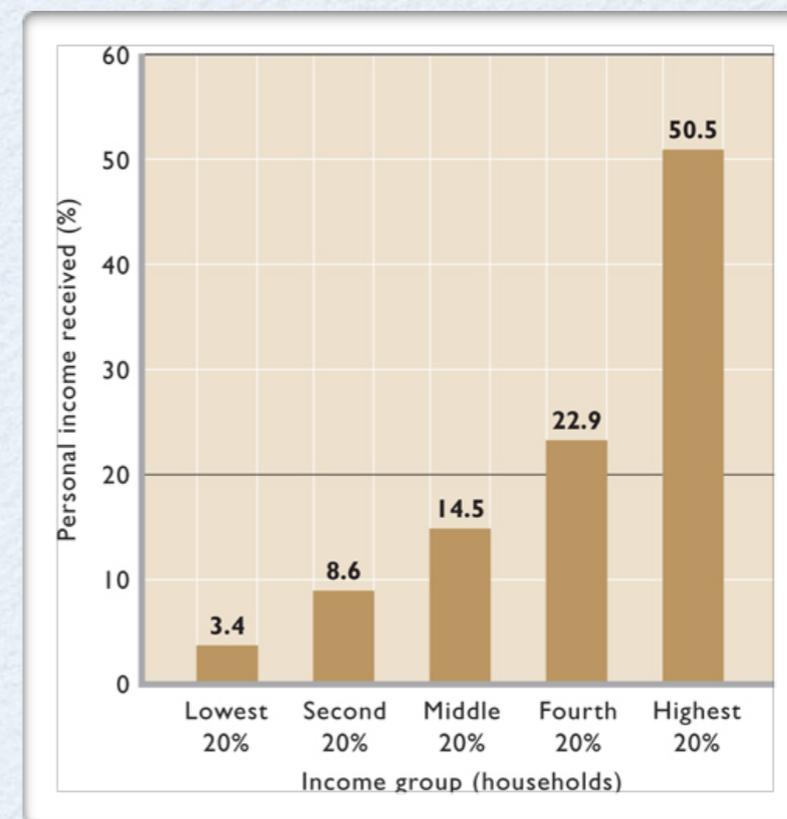
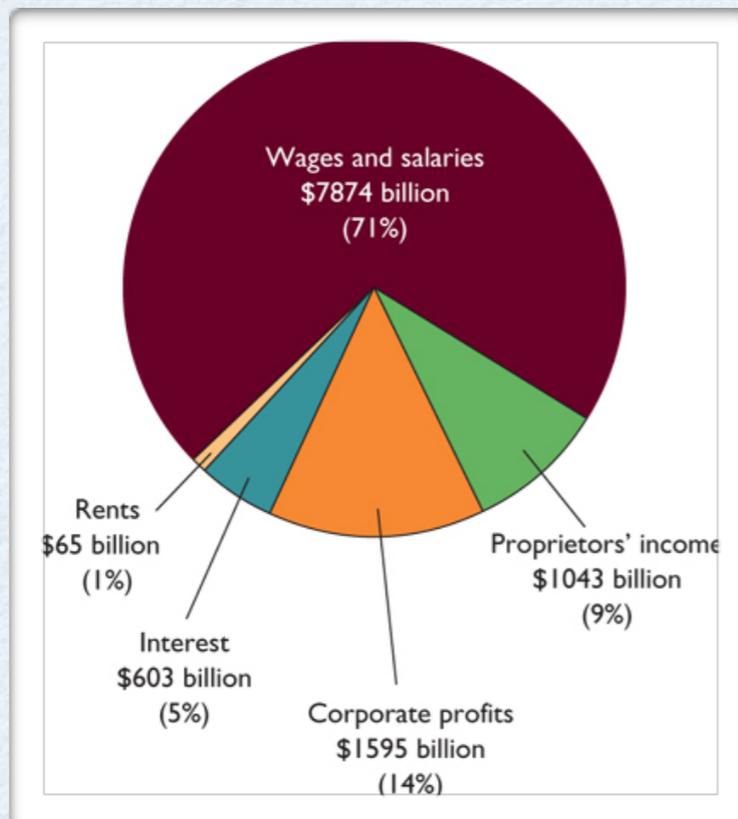


# Households as Income Receivers

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**Functional Distribution of Income** - indicates how a nation's income is apportioned among wages, rents, interest, and profits, that is, according to the function performed by the income receiver.

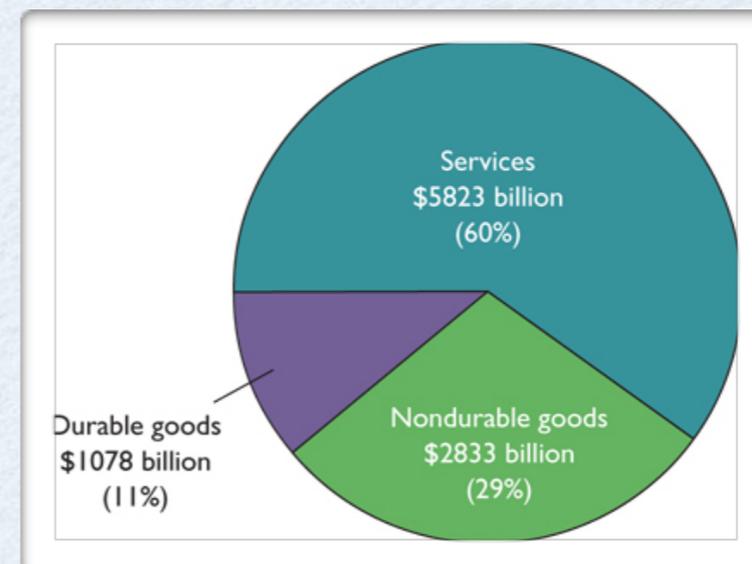
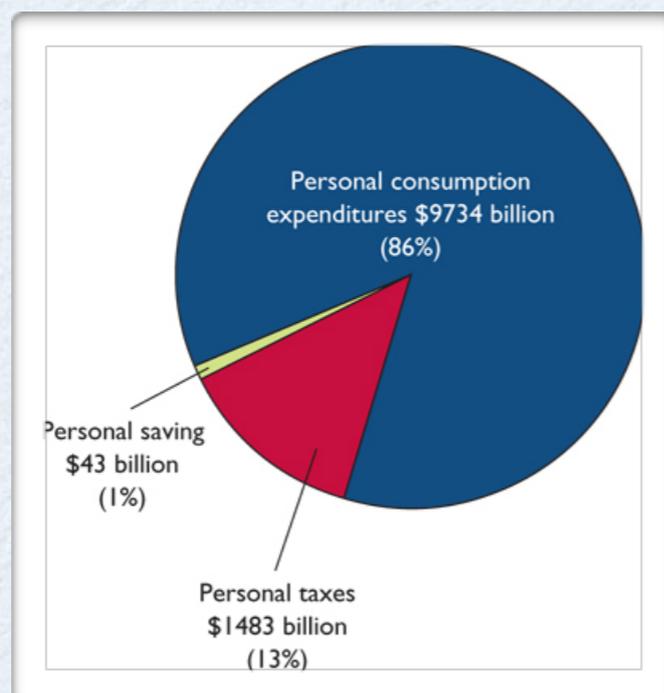
**Personal Distribution of Income** - indicates how the nation's total income is divided among individual households.



# Households as Spenders

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- **Personal Taxes** - paid to the government
- **Personal Savings** - the part of after tax income that is not spent
- **Personal Consumption** - the part of after tax income that is spent
  - **Durable goods** - goods that have an expected lives of 3 or more years
  - **Nondurable goods** - goods that have lives less than 3 years



# The Business Population

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- **Plant** - performs one or more functions in fabricating and distributing goods and services
- **Firm** - employs resources to produce goods and services for profit and operates one or more plants
  - *Horizontally integrated* - several plants performing the same function
  - *Vertically integrated* - plants that perform different functions in the various stages of the production process
  - *Conglomerate* - plants that produce products in several industries
- **Industry** - is a group of firms that produce the same, or similar, products

# Legal Forms of Businesses

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- **Sole proprietorship** - business is owned and operated by one person
- **Partnership** - two or more individuals operate a business together
- **Corporation** - is a legal creation that can acquire resources, own assets, produce and sell products, incur debts, extend credit, sue and be sued ... Stockholders own it, managers run it
  - **Advantages of a corporation**
    - **Financing** by selling *stocks* (equity financing) and *bonds* (debt financing) enables the corporation to pool large number of people's resources
    - **Limited liability** - personal assets are not in jeopardy if the corporation defaults on its debts
- **The principal-agent problem** - The principals are the stockholders who own the corporation. The agents are the ones who run the corporations. However, their interests often do not coincide. Shareholder wants profit maximization. Manager wants power, prestige, high pay ... Solution - make the managers owners.

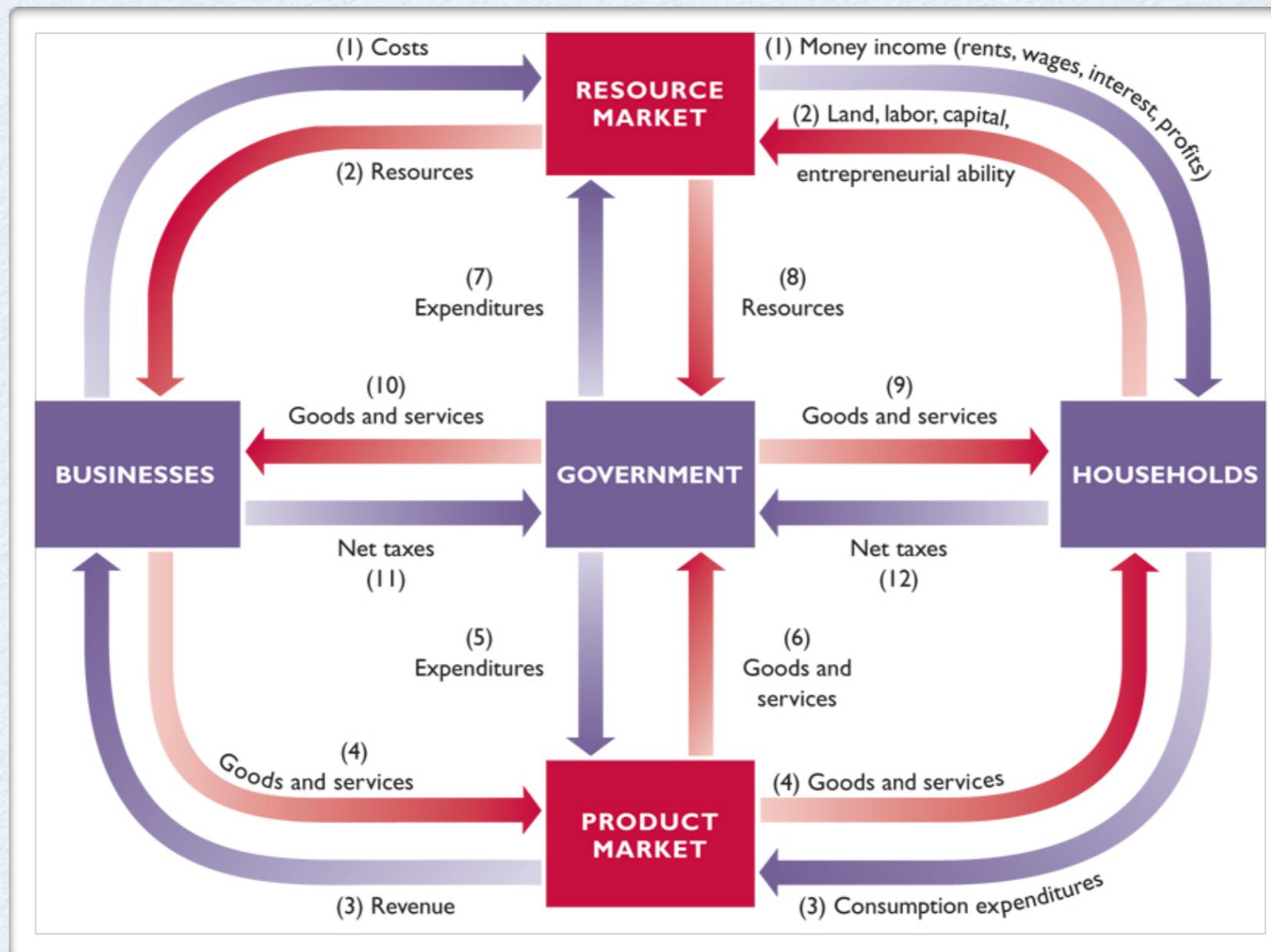
# The Public Sector: Government's Role

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- **Providing the legal structure** - “rules of the game” - supplying a medium of exchange, defines ownership rights, enforces contracts ...
- **Maintaining competition** - regulation through *antitrust laws* - monopoly is illegal
- **Redistributing income**
  - **Transfer payments** - welfare checks, food stamps, unemployment ...
  - **Market intervention** - minimum wage, farmers' above-market prices for their output ...
  - **Taxation** - personal income tax
- **Reallocating resources**
  - The “market produced” the wrong amount of goods and services
  - The market failed to allocate any resources to the production of certain goods and services whose output is economically justified
- **Promoting stability** - Fiscal policy and monetary policy to stabilize the economy

# The Circular Flow Revisited

- Businesses, government, and households
- Resource and product markets



# Government Finance

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- **Federal finance**
  - **Federal expenditures**
  - **Federal tax revenues**
    - *Personal income tax* - progressive tax
    - *Payroll taxes* - taxes based on wages and salaries
    - *Corporate income tax* - put on a corporation's profit
    - *Excise tax* - taxes on purchases
- **State and local finance**
  - *State finances* - sales and excise taxes, state income tax, corporate tax
  - *Local finances* - property taxes