

CHAPTER 2: THE MARKET SYSTEM AND THE CIRCULAR FLOW

Introduction

The problem of scarcity forces societies to make choices about what to produce, how to produce those goods, and who will receive the goods produced. But societies must first decide who will have the power to make those decisions: the government, the people, or both. Chapter 2 examines differences among economic systems and the role of the circular flow model in the market system. The framework of the market system and the role of incentives help to explain how consumers, producers, and governments make decisions. Material from Chapter 2 could appear in a multiple-choice question on either exam, with a question on consumer and firm incentives likely on the AP microeconomics exam and the circular flow model likely to appear on the AP macroeconomics exam.

Economic Systems

Every society must make choices about how to deal with scarcity. Economic systems are institutions and procedures that societies put in place to address the issues raised by unlimited wants and limited resources. Societies make their own choice of economic system by determining who owns and directs the factors of production: the government in the case of command economies or the people and firms in the case of market economies.

Command Economies

A central government makes the decisions in a command economy. The government owns most firms, and a central committee determines the allocation of resources among industries, production quotas for each firm, and prices and the distribution of products to consumers. The government makes production decisions based on long-term goals.

Socialist nations have a significant level of government involvement but not as much as communist nations. Such systems feature government ownership of major industries such as utilities, transportation, and health care but still allow significant private sector decision making. Essential goods may be rationed and incomes redistributed to equalize living conditions, but market forces determine production and prices in private industry.

Command economies have struggled in recent years because of problems coordinating consumer demand with production quotas, firms failing to meet quotas, and increasingly complicated economies overwhelming the ability of government planners to deal with them. In addition, the lack of a profit motive has stifled entrepreneurship, innovation, and capital accumulation, reducing the potential for long-run economic growth.

Market Economies

Market economies rely on markets rather than government to make economic decisions. Markets are mechanisms that bring buyers and sellers together to voluntarily exchange goods or services. Market economies put the decision making power in the hands of consumers and privately owned firms. Owners of firms make decisions based on a profit incentive, and consumers make decisions based on gaining the most satisfaction for the lowest possible price. Output and price decisions are made in markets through the power of supply and demand, eliminating the need for government planning committees.

Taking the EEK! Out of Economics

Markets can occur anywhere buyers and sellers come together. Don't limit your definition of "market" to a store. While stores are markets, they are not the only markets. Markets exist when a Girl Scout sells cookies to her neighbor, a fast food restaurant hires a worker, you buy a ticket to a school dance, or NASA buys rockets.

Mixed Economies

The extreme form of capitalism, *laissez faire*, calls for virtually no government involvement in society other than for the protection of private property and the market system. The form of capitalism used in the United States and other capitalist countries today is known as a mixed economy—free enterprise with some government regulation. While we rely on markets to make most of our economic decisions, our government is instrumental in providing public goods such as national defense and highways, redistributing income through progressive income taxes and supplemental income programs, regulating industry for worker and public safety, and stabilizing the economy through the use of taxes, government spending, and the money supply.

Characteristics of a Market Economy

The primary characteristic of a market economy is the private ownership of the factors of production—land, labor, capital, and entrepreneurial ability. People make their own decisions of whether to open a business and how to run it. The incentive of profit draws firms into industry, and private property protections preventing arbitrary government seizure give entrepreneurs the confidence to take the risk of starting a business. People in a market economy have the freedom to choose their careers and employers and to make decisions about the products they want to buy. Self-interest is the motivating factor for firms, workers, and consumers. Competition among buyers and sellers spreads out market power to keep prices down and provides firms the incentive to improve quality and innovation. Markets provide the mechanism for buyers and sellers to communicate information about tastes, prices, and production output. The market has its own system of rewards for firms that meet consumer demands and punishments for firms that do not.

Technological advance tends to be rapid in market economies because the rewards for invention and innovation go to those responsible for the work. Copyrights and patents guarantee ownership rights to creators, and sales result in monetary rewards, serving as an incentive for further innovation. Technological improvements and capital development increase our long-run production possibilities for future production.

Market economies rely on specialization and the division of labor to increase efficiency. In the same way, nations specialize, basing production on their best local resources and then trading. Because people and firms specialize, modern economies rely on money as a medium of exchange rather than on self-sufficient individuals making everything they need and bartering to get what they want. Money simply makes exchange easier.

Market economies are successful because they promote the most efficient use of resources, provide incentives for producers and workers, and allow producers and consumers the freedom to undertake activities that will best serve their own interests. While market economies focus on private decision making, the government still plays an important role in the economy. In situations where the market fails, government can perform important functions to improve efficiency and effectiveness in the markets.

Five Fundamental Questions

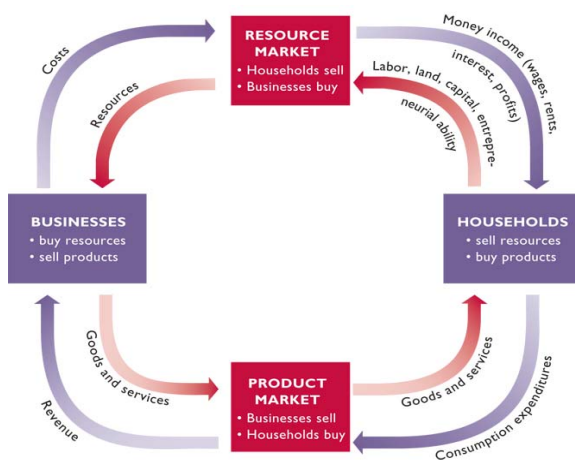
Because all societies face scarcity, every nation must make choices. The McConnell text notes five fundamental questions, while other books may focus on more or fewer.

1. What will be produced? In a market economy, products that result in profit for the producers will be produced. Consumer sovereignty—consumer demand driving the production decisions of firms—is central to a market economy.
2. How will goods be produced? In a market economy, goods are produced in the way that minimizes the cost per unit of production. Firms maximize their profits by finding the right combination of labor and capital and by using technology to lower costs.
3. Who will get the goods? In a market economy, goods go to those who are willing and able to pay for them. Those with higher incomes are able to buy more.
4. How will the system accommodate change? In a market economy, changes in consumer demand affect prices and profits, leading firms to change production. If demand and profits increase, firms produce more; if demand falls, firms produce less.
5. How will the system promote progress? In a market economy, increased profit can be used to invest in the accumulation of capital and development of technology to further increase production possibilities, the profits of firms, and standards of living.

The “Invisible Hand”

Adam Smith, known as the father of economics, explained the operation of market systems in his 1776 book *The Wealth of Nations*. He described how the “invisible hand” of self-interest leads firms and households to act in ways that benefit themselves as well as society. In the quest for profit, firms produce innovative and high-quality products that suit consumer tastes and demands. The quest for profit also leads firms to produce as efficiently as possible, reducing the waste of scarce resources that can be used to produce other goods. The quest for higher income encourages individuals to seek higher education and job training to command that higher wage. That education, in turn, benefits society by improving worker productivity and reducing production costs.

The Circular Flow Model



The circular flow diagram

The circular flow diagram shows how resources and products flow through the economy. In the resource (factor) market, households sell factors of production (land, labor, capital, and entrepreneurial ability) to firms, who use those resources to create products. In the product

market, firms sell goods to households. While goods flow one direction, money flows the other way. In the resource (factor) market, workers sell labor to firms in return for a paycheck. Workers use those checks in the product market to buy products from firms. The cycle continues as firms use that revenue to buy more factors of production.

In a market economy, the circular flow model operates without the need for government planning. The “invisible hand” of self-interest serves as the incentive for individuals and firms to act in ways that maximize their incomes and reduce their costs in the economy. The competition for resources and profits promotes productivity and low-cost production, helping us to use our scarce resources in the most efficient manner possible.

Bear in Mind

While few questions on the AP microeconomics and macroeconomics multiple-choice exams are likely to come from this chapter, a good understanding of the incentives and motivations involved in the market system is important to understand the decisions of consumers, workers, firms, and governments explored in later chapters. No free-response questions have been based specifically on material from this chapter.

Multiple-Choice Questions

1. Economic planning by central government agencies is primarily associated with
 - (A) command economies.
 - (B) market economies.
 - (C) laissez faire economies.
 - (D) mixed economies.
 - (E) traditional economies.

2. In market economies, the incentive that draws entrepreneurs into industry is
 - (A) government bonuses for meeting production quotas.
 - (B) profit.
 - (C) government assumption of the risk of failure.
 - (D) government assistance with making output and pricing decisions.
 - (E) a guaranteed minimum income level.

3. In a mixed economy, the economic decisions of what to produce, how to produce, and who will receive products are made by
 - (A) the government.
 - (B) consumers and firms.
 - (C) banks and stock markets.
 - (D) firms, consumers, and government.
 - (E) banks and the government.

4. Fundamental economic questions that every society must answer include
 - I. What will be produced?
 - II. How will goods be produced?
 - III. How will goods be distributed to consumers?
 - (A) I only
 - (B) III only
 - (C) I and II only
 - (D) II and III only

- (E) I, II, and III
5. What did economist Adam Smith identify as the “invisible hand” that directs the decision making of firms and households in a market economy?
- (A) government
 - (B) product demand
 - (C) self-interest
 - (D) international trade
 - (E) entrepreneurial ability
6. In the product market of the circular flow model,
- (A) firms buy finished products from households.
 - (B) consumers buy factors of production from firms.
 - (C) firms sell factors of production to the government.
 - (D) consumers buy finished products from firms.
 - (E) firms buy factors of production from consumers.
7. Which of the following activities would occur in the resource (factor) market?
- (A) A teacher buys a new truck from a car dealership.
 - (B) The department of defense buys a tank from a weapons manufacturer.
 - (C) A farmer buys farmland from a retiring farmer.
 - (D) A retirement fund buys stock in a major corporation.
 - (E) A welder buys a personal home computer from an electronics store.
8. While resources and products flow in one direction of the circular flow model, what flows the other direction?
- (A) money
 - (B) services
 - (C) public goods
 - (D) imported goods
 - (E) information

Multiple-Choice Explanations

1. (A) Government planning is the hallmark of a command economy; in other economies, individuals and firms play the central role in decision making.
2. (B) The profit motive draws new firms into industry in market economies, because private property rights allow firms to keep those profits.
3. (D) Mixed economies provide for some government intervention, such as regulation and provision of public goods, but primarily rely on the decision making of firms and consumers in markets.
4. (E) Scarcity forces societies to answer these and other questions about economic growth and security.
5. (C) In *The Wealth of Nations*, Adam Smith recognized that, in market economies, market participants make decisions to benefit themselves.
6. (D) In the product market, firms sell products to consumers.
7. (C) In the resource (factor) market, firms buy factors of production (land, labor, capital, and entrepreneurial ability) from resource providers.
8. (A) Money, in the form of paychecks, profit, and other payments, serves as an incentive for households to provide resources and firms to produce products in a market economy.