Chapter 2
The Market System and the Circular Flow

Chapter Overview
This chapter begins with a brief comparison of the command and market systems, transitioning quickly to a discussion of the institutional framework of the American market system. Brief explanations are given for these characteristics of the market system: private property, freedom of enterprise and choice, the role of self-interest, competition, markets and prices, the reliance on technology and capital goods, specialization, use of money, and the active, but limited role of government. The authors then address the Five Fundamental Questions faced by every economy and explain how a market economy answers each one. A discussion of Adam Smith’s “invisible hand” leads into an explanation of why command systems have failed. The final part of the chapter introduces the circular flow model as an overview of how resources and goods move through a market system.

Instructional Objectives
After completing this chapter, students should be able to:

1. Highlight the main features of a market economy and a command economy.
2. List and explain the important characteristics of the American market system.
3. State the Five Fundamental Questions faced by any economic system.
4. Describe how the market system answers each of these five fundamental questions.
5. Explain how the consumer influences the “What goods and services will be produced?” question.
6. Explain how a market system achieves economic efficiency.
7. Explain how markets answer the “Who will get the output?” question.
8. Describe how prices drive the movement of resources in a market system.
9. Describe how the market system promotes technological improvements and capital accumulation.
10. Explain the role of self-interest and “invisible hand” in promoting economic efficiency.
11. Explain why the command systems of the Soviet Union, Eastern Europe, and China failed.
12. Identify the decision makers and the markets in a market system using the circular flow diagram.
13. Identify the two roles each that households and businesses play using the circular flow diagram.
15. Define and identify terms and concepts listed at the end of the chapter.

Lecture Notes
I. Learning objectives – In this chapter students will learn:
   A. The difference between a command system and a market system.
   B. The main characteristics of the market system.
   C. How the market system decides what to produce, how to produce it, and who obtains it.
   D. How the market system adjusts to change and promotes progress.
The mechanics of the circular flow model.

II. Economic Systems

Economic systems differ in two important ways: Who owns the factors of production and the method used to coordinate economic activity.

A. Command economy, socialism or communism:
   1. There is public (state) ownership of resources.
   2. Economic activity is coordinated by central planning

B. The market system:
   1. There is private ownership of resources.
   2. Markets and prices coordinate and direct economic activity.
   3. Each participant acts in his or her own self-interest.
   4. In pure capitalism the government plays a very limited role.
   5. In the U.S. version of capitalism, the government plays a substantial role.

III. Characteristics of the Market System

A. Private individuals and firms own most of the private property (land and capital).
   1. Private property, coupled with the freedom to negotiate binding legal contracts, enables individuals and businesses to obtain, control, use, and dispose of this property.
   2. Private property rights encourage investment, innovation, exchange of assets, maintenance of property, and economic growth.
   3. Property rights extend to intellectual property through patents, copyrights, and trademarks.

B. Freedom of enterprise and choice exist.
   1. Freedom of enterprise means that entrepreneurs and businesses have the freedom to obtain and use resources, to produce products of their choice, and to sell these products in the markets of their choice.
   2. Freedom of choice means:
      a. Owners of property and money resources can use resources as they choose.
      b. Workers can choose the training, occupations, and job of their choice.
      c. Consumers are free to spend their income in such a way as to best satisfy their wants.

C. Self-interest
   a. Self interest is one of the driving forces in a market system. Entrepreneurs try to maximize profits or minimize losses; resource suppliers try to maximize income; consumers maximize satisfaction.
   b. As each tries to maximize profits, income, satisfaction, the economy will benefit if competition is present.

D. Competition among buyers and sellers is a controlling mechanism.
   1. Large numbers of sellers mean that no single producer or seller can control the price or market supply.
2. Large number of buyers means that no single consumer or employer can control the price or market demand.

3. Depending upon market conditions, producers can enter or leave industry easily.

**E. Markets and prices**
1. A market system conveys the decisions of the many buyers and sellers of the product and resource markets.
2. A market is an institution or mechanism that brings buyers and sellers into contact.
3. Individual decisions by buyers and sellers in the market determine the product and resource prices that, in turn, guide further decisions by resource owners, producers, and consumers.
4. Those who respond to the market signals will be rewarded with profits and income.

**F. Reliance on technology and capital goods**
1. Competition, freedom of choice, self-interest, and the potential of profits provide the incentive for capital accumulation (investment).
2. Advanced technology and capital goods promote efficiency and greater output.

**G. Specialization**
1. Division of labor allows workers to specialize.
   a. People can take advantage of differences in abilities and skills.
   b. People with identical skills may still benefit from specialization and improving certain skills. (Learning by doing)
   c. Specialization saves time involved in shifting from one task to another.
2. Geographic specialization: Regional and international specialization take advantage of localized resources.

3. **Consider This … Buy American?**
   a. The logic of “buying American” – favoring domestically produced goods, taken to its logical extreme would lead to the conclusion that each individual should be self-sufficient.
   b. Specialization allows us to enjoy a greater volume of output. We would all be poor if left to produce for ourselves, largely because of the absence of specialization.

**H. Use of money as a medium of exchange**
1. Money substitutes for barter, which requires a coincidence of wants. (I may want what you produce but you may not want to exchange for what I have.)
2. Willingness to accept money in place of goods permits 3-way trades (or multilateral trades). See Figure 2.1 and examples in text.
   a. Floridians give money to Nebraskans for wheat, who give money to Idahoans for potatoes, who give money to Florida for oranges.
b. Foreign exchange markets permit Americans, Japanese, Germans, Britons, and Mexicans to complete international exchanges of goods and services.

c. Detroit autoworker produces crankshafts for Buicks. If the worker were paid in crankshafts, he would have to find grocers, clothing retailers, etc., who would be willing to exchange their products for a crankshaft. It is much more efficient to use money wages than to accept one’s wages in crankshafts!

I. Active, but limited government
1. Although the market system promotes efficiency, it has certain shortcomings (over production of goods with social costs, under production of goods with social benefits, tendency for business to increase monopoly power, macro instability).

2. Chapter 4 deals with how the government can increase the overall effectiveness of the market system.

IV. Five Fundamental Questions
A. Although the focus of this chapter is on the market system, the five fundamental questions must be answered by all economic systems.

1. What goods and services will to be produced?
2. How will the goods and services be produced?
3. Who will get the output?
4. How will the system accommodate change?
5. How will the system promote progress?

B. What will be produced?
1. In order to be profitable, businesses must respond to consumers’ (individuals, other businesses, and the government) wants and desires.

2. Consumer Sovereignty
   a. Consumer sovereignty is the key to determining the types and quantities of the various products that will be produced. “Dollar votes” for a product when purchases are made and “dollar votes” against a product when products are ignored will determine which industries continue to exist and which individual products survive or fail.

   b. Consider This … McHits and McMisses
      In an effort to stimulate demand and respond to market trends and conditions, McDonald’s has introduced a number of new menu items over the years. The success and failure of these new items illustrates the important role of the consumer in determining what will be produced.

   c. Businesses are not really “free” to produce what they wish. They must match their production choices with consumer choices or face losses and eventual bankruptcy. Profit-seeking firms must consider the allocation of the “dollar votes” when they make their production decisions.

3. As with producers of consumer goods and services, decisions of resources suppliers are driven by the desires of consumers for the products produced by the resources they own.

C. How will the goods and services be produced?
1. The market system encourages and rewards those producers who are achieving least-cost production.

2. Least-cost production techniques include: locating firms in the optimum location considering resource prices, resource productivity, and transportation costs, available technology, and resource prices in general.

3. The most efficient technique will be the one that produces a given amount of output with the smallest input of scarce resources when both inputs and outputs are measured in dollars and cents.

D. Who will get the output?

1. The answer to this question is directly related to how the income is distributed among the individuals and the households and the tastes and preferences of consumers.

2. Products go to those who are willing and able to pay for them.

3. The productivity of the resources, the relative supply of particular resources, and the ownership of the resources will determine the income of individuals and households.

4. The resource markets, which determine income, are linked to this decision.

E. How will the system accommodate change?

1. Markets are dynamic – what is efficient today may not be efficient tomorrow as tastes, technology, and resource supplies change. Prices help signal those changes.

2. An increase in demand for some products (fruit juice) will lead to higher prices in those markets; a decrease in demand for other products (milk) will lead to lower prices in those markets.

3. Increased demand leads to higher prices that induce greater quantities of output from suppliers. The opposite is true for a decrease in demand.

4. Higher prices lead to more profits and new firms entering the market; lower prices lead to losses and firms leaving the industry.

5. The guiding function of prices is essential to a well-functioning market system. In the absence of such signals, government or some similar institution would have to decide where resources are allocated, but without knowing what people in society want.

F. How will the system promote progress?

1. The market system promotes technological improvements and capital accumulation.

2. An entrepreneur or firm that introduces a popular new product will be rewarded with increased revenue and profits.

3. New technologies that reduce production costs, and thus product price, will spread throughout the industry as a result of competition.

4. Creative destruction occurs when new products and production methods destroy the market positions of firms that are not able or willing to adjust.

5. Technological advances often require additional capital. Entrepreneurs cast “dollar votes” for capital, drawing resources to the production of capital goods.
V. **Competition and the “Invisible Hand”:**

A. Competition is the mechanism of control for the market system. It not only guarantees that industry responds to consumer wants, but it also forces firms to adopt the most efficient production techniques.

B. Adam Smith talked of the “invisible hand” which promotes public interest through a market system where the primary motivation is self-interest. By attempting to maximize profits, firms will also be producing the goods and services most wanted by society.

C. Of the many merits of the market system, three stand out:
   1. Market systems promote *efficiency* in the allocation of resources.
   2. Market systems provide *incentives* for people to be productive through work effort and acquiring skills.
   3. Market systems provide a lot of personal *freedom* in making economic decisions.

VI. **The Demise of the Command Systems**

Command systems in the Soviet Union, Eastern Europe, China eventually gave way to market systems. The failure of command systems can be attributed to two main problems:

A. Coordination problem – it was difficult (if not impossible) for central planners to effectively coordinate the allocation of resources and satisfaction of wants of millions of consumers, resource suppliers, and businesses.
   1. If an industry failed to meet production targets it could disrupt production and resource allocation throughout the system.
   2. Larger planned economies faced even greater difficulties because the greater number and complexity of allocation decisions to be made.
   3. Without market signals (i.e. prices) it was difficult to measure success. Even if quantitative production targets were met, ambiguities in the targets led to perverse outcomes in terms of poor quality, excessive costs, and the wrong mix of goods.

B. Incentive problem – with central planners determining what and how much would be produced, and how much resource suppliers would receive, there was little incentive to innovate, contain costs, or otherwise improve the quantity and quality of goods and services.

VII. **The Circular Flow Model for a Market-Oriented System (Key Graph 2.2)**

A. There are two groups of decision makers in the private economy (no government yet): households and businesses.
   1. The market system coordinates these decisions.
   2. What happens in the resource markets?
      a. Households sell resources directly or indirectly (through ownership of corporations).
      b. Businesses buy resources in order to produce goods and services.
      c. Flow of payments from businesses for the resources constitutes business costs and resource owners’ incomes.
   3. What happens in the product markets?
      a. Households are on the buying side of these markets, purchasing goods and services.
      b. Businesses are on the selling side of these markets, offering products for sale.
c. Flow of consumer expenditures constitutes sales receipts for businesses.

4. Circular flow model illustrates this complex web of decision-making and economic activity that give rise to the real and money flows.

B. Limitations of the model (not in text):
   1. Does not depict transactions between households and between businesses.
   2. Ignores government and the “rest of the world” in the decision-making process.
   3. Does not explain how prices of products and resources are actually determined, but this is explained in Chapter 3.

VIII. LAST WORD: Shuffling the Deck
   A. If one thoroughly shuffles a deck of cards, there is a virtual 100% chance that the resulting arrangement of cards will be unlike any previous arrangement.
   B. Yet, even though there are tens of billions of resources in the world, these resources are arranged in such a way as to produce the products and services that serve human needs.
   C. Private property eliminates the possibility that resource arrangements will be random because each resource owner will choose a particular course of action if it promises rewards to the owner that exceed the rewards promised by all other available actions.
   D. The result is a complex and productive arrangement of countless resources.