Econ 200 Chapter 2: Overview of ideas: VOLUNTARY EXCHANGE MAKES PEOPLE BETTER OFF

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 Laissez-Faire 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** (Laissez-Faire capitalism) the government plays a very limited role.
   5. In the U.S. the government plays a large role. It is best categorized as a **mixed economy**.

*Libertarian (TRUE or ***Classical*** LIBERAL), republican, centrist, democrat, socialist, communist

*Venezuela and Exxon, Zimbabwe and Farmland

*TV Shows: How Its Made, Shark Tank

II. Characteristics of the Market System

A. Private individuals and firms own most of the private property (land and capital).
   1. Private property: individuals can contract, obtain, control, use, rent, improve, and dispose of this property.
   2. Private property rights spur mutually agreeable transactions.
   3. Private property rights encourage investment, innovation, trade, improvement of property, & growth.
   4. 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
   1 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 (utility).
   2 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. **(Competitive markets)**
   1. Large numbers of sellers mean that no single producer or seller can control the price or market supply.
   2. Large number of buyers: no single consumer or employer can control the price or market demand.
   3. Depending upon market conditions, producers can enter or leave industries easily.

E. Markets and prices
   1. A market system processes 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. *Adam Smith quotes: butcher baker and pins
   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) Specialization saves time shifting from one task to another.
2. Geographic specialization: Regional/international specialization take advantage of local resources.

H. Active, but limited government

1. Although the market system promotes efficiency, it has shortcomings (goods with social costs, goods with social benefits, tendency for business to increase monopoly power, macro instability).
2. Chapters 4 and 5 deal with how the government can increase the overall effectiveness of the market

I. Use of money as a medium of exchange

1. Money instead of barter, which requires a coincidence of wants. (We have to want what each other have)
2. Willingness to accept money in place of goods permits 3-way trades (or multilateral trades).
   a. Floridians → $$ Nebraska for wheat, Nebraska →$$ Idaho for potatoes, Idaho →$$ Florida oranges.
   b. Foreign exchange markets permit worldwide exchanges of goods/services.
   c. Detroit autoworker produces crankshafts for cars. If the worker were paid in crankshafts…

"On the Economic Orgsanisation of a POW Camp" by RA Radford (1945, WWII)

Voluntary Exchange is good! But is if it is difficult or limited, it won't happen.

MONEY- easier to make exchange. Cigarettes in POW camps. Barter with 10 goods, how many prices?

PRICES communicate information about opportunity costs, and where more happiness can be found, and how more profit can be earned.

III. Five Fundamental Questions

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?

IV. 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

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.

V. 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.

C. Consider This … The Two Koreas

1. North Korea, under the influence of the Soviet Union, established a command economy emphasizing government ownership and central government planning.
2. South Korea, protected by the U.S., established a market economy based on private ownership and profit motive.
3. South Korea has experienced significantly higher GDP, GDP per capital, exports, and imports than North Korea, which maintains an agrarian economy.

VII. How the Market System Deals with Risk

A. The Profit System

1. It falls to those acting as the firm's entrepreneurs to deal with risk
2. The entrepreneurs are guided by the so-called profit system. These individuals bear the risk; they win if there is a gain in profit and lose if there is a loss. Therefore, entrepreneurs must make prudent decisions to avoid unnecessary risks.
3. Command economies do not manage risk well because the central planners do not face the risk themselves.

B. Shielding Employees and Suppliers from Business Risk

1. Under the market system, only a firm's owners are subject to business risk and the possibility of losing money.
2. The firm's employees and suppliers are not subject to profit risk. However, employees may bear employment risk, which depends on the profitability of the firm.

C. Benefits of Restricting Business Risk to Owners

1. Attracting Inputs: By concentrating risk on the owners of a firm it allows the firm to attract employees and suppliers.
2. Focusing attention: Profit maximizing behavior by the firm helps achieve prudent risk management.

D. Insurance!

Insurance promotes economic growth and investment by transferring risk from those who hate risk to those who don't mind it. Insurance also promotes growth and development by allowing individuals to pool the risk across a number of different individuals.

VI. The Circular Flow Model for a Market-Oriented System

A. There are two groups of decision makers in the private economy (when government has not yet been included): 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.