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Markets and Economies

Anderson, Survey of Economics 1e

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LEARNING OBJECTIVES

1. Identify the factors of production
2. Discuss the participants in an economy
3. Explain how households, firms, and the government interact within an economy
4. Describe what efficiency means to an economist
5. Compare traditional economies, market economies, and command economies

FACTORS OF PRODUCTION

- **Factors of production** are the building blocks of goods and services.
  - These are also known as *resources* or *inputs*.

- There are four general categories:
  - Land
  - Labor
  - Capital
  - Entrepreneurship

- Everything is made from some combination of these.

LAND AND LABOR

- **Land** represents the earth and everything drawn from it**.**
  - This includes water, minerals, plants, and animals.
  - The wood used for paper and the cacao beans used for chocolate fall into this category.

- **Labor** is the physical and mental contribution of people to the production process.
  - This includes the work of any employee of any company.

CAPITAL AND ENTREPRENEURSHIP

- **Capital** refers to the manufactured goods used to produce other goods or services.
  - Examples include construction equipment, factories, trucks, sewing machines, and chocolate molds.
- **Entrepreneurship** is the willingness and ability to take risks, initiate productive activities, innovate, and organize the other factors of production to provide goods and services.
- If there is no entrepreneur in an area who is willing to open a fondue restaurant, then no fondue restaurants will be opened in that area.

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AN ECONOMY'S PARTICIPANTS

- An economy's participants include households, firms, and the government.
- These groups own the factors of production and are responsible for transforming them into goods and services.
- A **household** is a person or group of people living together and sharing income.
  - Households provide labor and entrepreneurship to firms.
  - In some cases, households own land and capital as well.
- In exchange for factors of production, households receive income.

FIRMS

- A **firm** is any enterprise that employs factors of production and sells goods or services.
- There are many different ways of organizing a firm:
  - Sole proprietorship
  - Partnership
  - Corporation
  - Limited liability company
- A **sole proprietorship** is owned and controlled by an individual.
- Kee's Chocolates, for example, is owned solely by Kee Ling Tong.

Dave Anderson

SOLE PROPRIETRORSHIPS AND PARTNERSHIPS

- A **partnership** is similar to a sole proprietorship, except that two or more people own and control it.
- Partners share the risks, obligations, and rewards of running the firm.

- Both of these firm types allow for quick action and simple taxation.

- The downside is that owners are personally liable for debts, court judgments against the firms, and other legal obligations of businesses.

- Also, sources of funding are limited compared to corporations.

CORPORATIONS

- A **corporation** is a firm that exists as a legal entity distinct from its owners.
- About 20% of U.S. businesses are corporations, and they receive more than 85% of all spending at businesses.
- Corporations are created when business leaders file *articles of incorporation* with a state government.
- Because corporations are separate legal entities, owners are less liable in the event of a lawsuit.

STOCKS

- To raise funds, corporations can sell shares of ownership, known as **stocks**.
- Investors who own stock are called **shareholders**.
- Many corporations distribute a portion of their profits to shareholders via payments called **dividends**.

- Nestlé, the maker of Crunch chocolate bars, is one such corporation.
- Shareholders of Nestlé stock own part of Nestlé.

Susana Gonzalez/Bloomberg via Getty Images

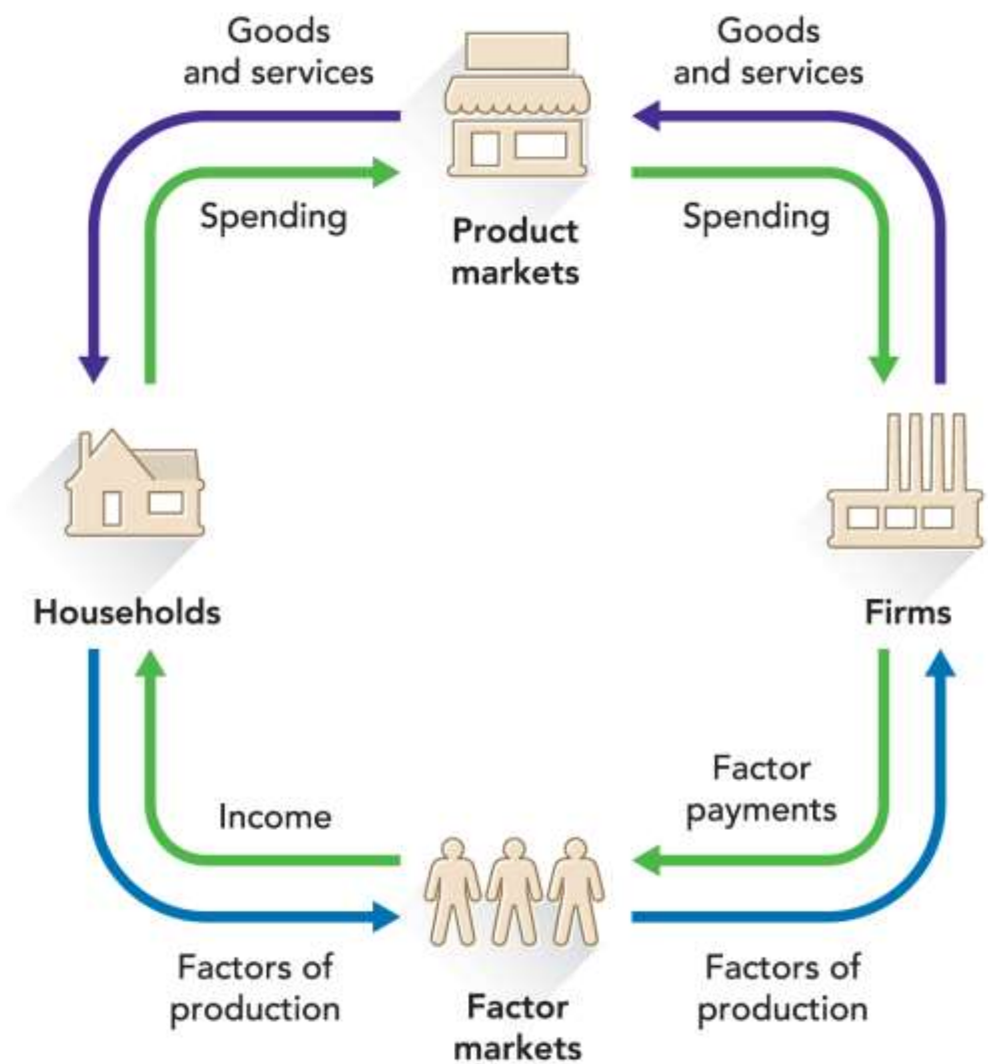
LIMITED LIABILITY COMPANY

- A **limited liability company (LLC)**, like a corporation, is a legal entity distinct from its owners.
- Unlike a corporation, LLCs cannot sell stock, and owners of LLCs are referred to as *members*.
- An advantage of LLCs is that they face fewer paperwork requirements than corporations while still enjoying similar legal benefits.

GOVERNMENT

- A **government** is an organization of individuals that has the authority to lead and govern.
- The government collects taxes from households and firms to fund its programs and operations.
- **Transfer payments** are government payments that are not made in exchange for goods or services.
  - Examples include grants, social security, welfare, and subsidies.

THE CIRCULAR FLOW (FACTOR MARKETS)



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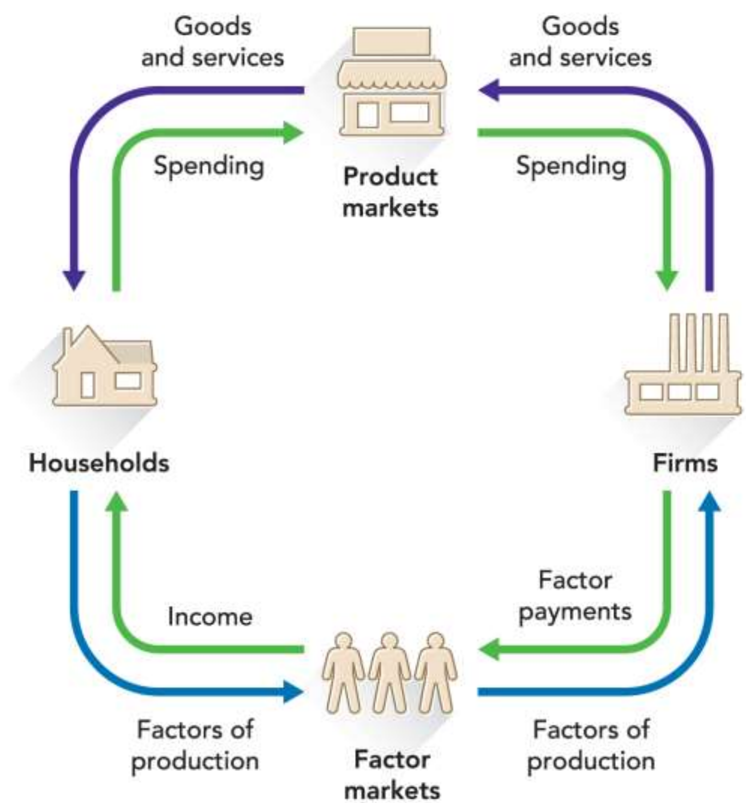
- The **circular-flow diagram** illustrates how goods, services, and money flow throughout an economy.
- Households provide firms with factors of production in **factor markets** in exchange for income.
- Factor markets are made up of all of the buyers and sellers of factors of production in an economy.

THE CIRCULAR FLOW (PRODUCT MARKETS)

- All of the producers and consumers of goods and services in an economy make up **product markets**.



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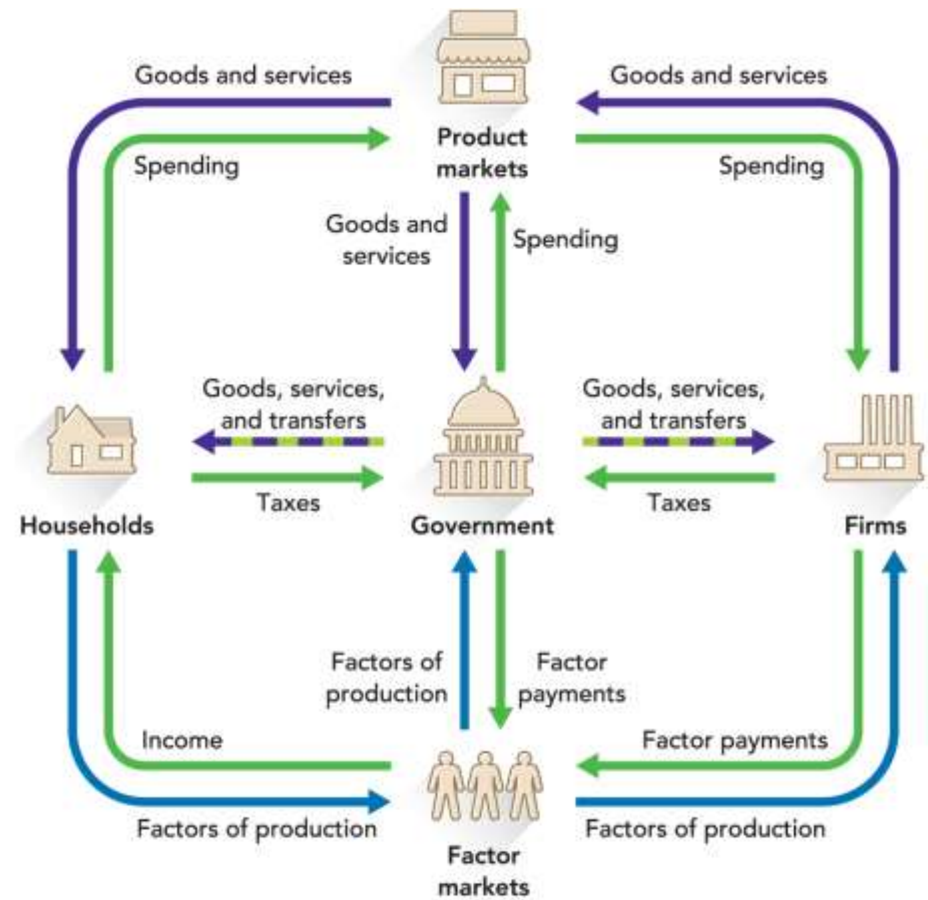
- Households purchase goods and services from firms in the product market.
- If companies expect consumers to buy less, they will decrease production, thus decreasing consumers' income, which will cause consumers to buy less.
- In this way, expectations can create reality.

GOVERNMENT AND THE CIRCULAR FLOW

- The modified diagram on the right shows how the government interacts with firms, households, and each type of market.



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- Households and firms pay taxes, which the government spends in both markets in exchange for goods, services, and factors of production.

- The government uses these goods and services, as well as transfer payments, to benefit households and firms.

LEARN BY DOING: PRACTICE QUESTION 1

Which of these statements are true?

I. Households provide firms with both money and goods.

II. Firms provide households with both income and goods.

III. Households and firms both provide the government with money.

a) I and II only

b) II and III only

c) I and III only

d) I, II, and III

LEARN BY DOING: PRACTICE QUESTION 1 (Answer)

Which of these statements are true? Households provide firms with both money and goods.

I. Firms provide households with both income and goods.

II. Households and firms both provide the government with money.

a) I and II only

b) II and III only (correct answer)

c) I and III only

d) I, II, and III

THE GOAL OF EFFICIENCY

- The economist Vilfredo Pareto (1843–1929) deemed an allocation of resources to be **efficient** if no alternative allocation could make some people better off without making other people worse off.
- Efficiency is a central objective in making economic decisions.
- Under the right conditions, markets create incentives for efficient answers to the three fundamental economic questions:
  1. What should be produced?
  2. How should it be produced?
  3. For whom should it be produced?

WHAT SHOULD BE PRODUCED?

- Efficiency in resource allocation is achieved when no alternative mix of goods and services would make society better off.
- Market forces lead to efficiency by guiding firms to produce more of the goods and services that consumers most need and want.
- In certain circumstances, market forces can lead to inefficient outcomes.

HOW SHOULD IT BE PRODUCED?

- Efficiency in production is achieved when firms employ the capital, labor, and other inputs that minimize the cost of producing the desired quantity of output.
- In this case, no more of any one good or service can be produced without making less of something else.

- Economies must choose between labor and machines when harvesting cacao pods and when mixing chocolate ingredients.
- Workers are more efficient at harvesting; machines are more efficient at mixing.

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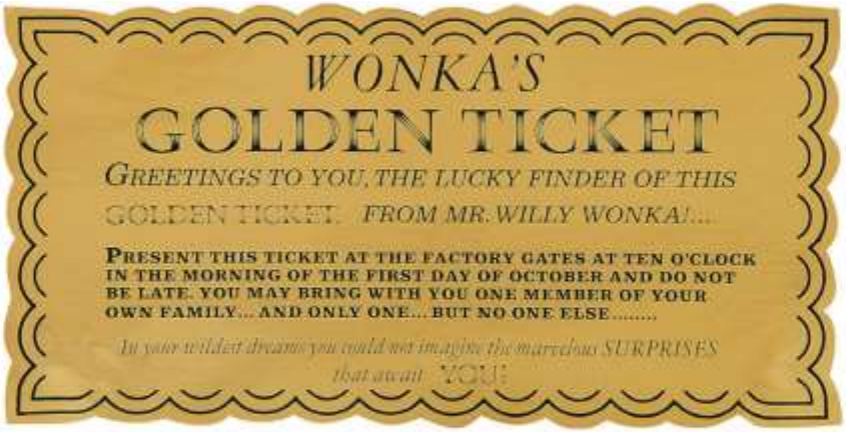
FOR WHOM SHOULD IT BE PRODUCED?

- Efficiency in distribution is achieved when the people who receive particular goods and services are the ones who place the highest value on them.



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- Lotteries are inefficient because winners of a good are chosen by luck, not by the value that they place on the item.

- Auctions are efficient because goods go to those who are willing and able to place the highest bid on them.

EFFICIENCY AND EQUITY

- Efficiency is achieved in an economy when firms individually pursue efficiency.
- Efficient outcomes are not necessarily fair or *equitable*.
- The goal of efficiency can conflict with the goals of helping people cope with unemployment, injury, and poverty.
- A tax that collects from the rich and gives to the poor might be equitable, but it is inefficient.

ECONOMIC SYSTEMS

- Economic systems determine the answers to the questions of *what* goods and services are produced, *how* they are produced, and *for whom* they are produced.

- In most countries, the economic system contains elements of traditional economies, market economies, and command economies.

- An economic system with characteristics of all three of these types of economies is known as a **mixed economy**.

TRADITIONAL ECONOMIES

- In a **traditional economy**, economic decisions are made on the basis of precedent.
- Traditional economies serve the needs of small and simple societies, such as Amish communities.
- As societies have grown, the roles of markets and governments in economic decision making have expanded.

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MARKET ECONOMIES PART I

Oleksiy Maksymenko/imageBROKER/AGE Fotostock

- In a **market economy**, or **capitalist economy**, households own the factors of production.
- Market forces tend to push the economy toward efficiency.
- For example, Disney built amusement parks in Japan and China because the high demand in the U.S. among Asian tourists showed Disney that it could increase profits by doing so.

MARKET ECONOMIES PART II

- High prices lead firms to produce more and consumers to consume less.
- Low prices lead firms to produce less and consumers to consume more.
- In this way, markets push toward efficiency.
- One weakness of market economies is that sometimes the people who value a good the most are unable to afford it.
  - For example, some people are unable to afford college.
- Another issue is that goods that benefit many people are unlikely to be purchased by an individual consumer.
  - Roads and police protection are too expensive for a single person to purchase, so government intervention is usually needed.

COMMAND ECONOMIES

- In a **command economy**, economic decision making is centralized and made by the government or citizen groups.
- Factors of production are collectively owned.
- Decisions are made in line with goals such as full employment and an equitable distribution of income.
- This sharing tends to give people less incentive to work hard, to take risks, and to innovate.

- There are two kinds of command economies:
  - communism
  - socialism

COMMUNISM

- Under **communism**, legislators from a single political party—the Communist party—determine production levels and wage rates.
- There are no private firms because everything is owned and operated by the government.
- Goods and services are divided among citizens according to their needs.
- The ultimate goal is to allow everyone to share equally in the gains from productive activities and to eliminate the distinctions of social class.

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SOCIALISM

- Under **socialism**, general assemblies and councils of workers and consumers make economic decisions, sometimes with government oversight.
- In countries with a substantial degree of socialism, such as Iceland, New Zealand, and Sweden, tax rates are relatively high in order to pay for publicly funded services, such as health care and education.
- These countries tend to rank near the top in studies that measure citizens' happiness and satisfaction.

INNOVATION

- The table on the right shows the origins of some of the world's most important inventions.
- Every invention listed here has come from market-based economies.
- Innovation does not often occur in command economies due to reduced incentives.

Invention	Year	Country
World Wide Web	1990	United States/United Kingdom/France
Computer	1936	Germany/United Kingdom
Penicillin	1928	United Kingdom
Radio	1895	Italy
Film	1890	United Kingdom/United States
Automobile	1885	Germany
Television	1884	Germany/United States
Telephone	1875	Italy/Germany/United States
Sewing machine	1830	France
Camera	1814	France
Light bulb	1809	United Kingdom/Germany
Cotton gin	1794	United States
Steam engine	1698	United Kingdom
Printing press	1440	Germany

MIXED ECONOMIES

- The vast majority of modern economies are mixed economies, combing what they hope are the best characteristics of each type of economic system.

- In the United States, for example:
  - Governments provide national defense, transportation systems, and health care (element of command economy).
  - Some firms use traditional production methods, even though there are cheaper methods available. Also, Amish and American Indian communities are highly traditional. (elements of traditional economy).
  - Despite these elements, the U.S. is primarily market based.

LEARN BY DOING: PRACTICE QUESTION 2

If all income in an economy with 50 workers is shared equally, the rewards for extra effort are equivalent to the rewards for working under a tax on output of what percent?

a) 0%
b) 2%
c) 50%
d) 98%

LEARN BY DOING: PRACTICE QUESTION 2 (Answer)

If all income in an economy with 50 workers is shared equally, the rewards for extra effort are equivalent to the rewards for working under a tax on output of what percent?

a) 0%

b) 2%

c) 50%

d) 98% (correct answer)