Chapter 2: The Market System and Circular Flow

Learning objectives:
- Differentiate between laissez-faire capitalism, the command system and the market system.
- List the main characteristics of the market system.
- Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
- Explain the operation of the Invisible Hand and why market economies usually do a better job than command economies at transforming economic resources into desirable output.
- Describe the mechanics of the circular flow model.
- Explain how the market system deals with risk.

How is it decided which goods and services will be produced, how they will be produced, and who will buy them?

Economic systems

Every society chooses an economic system, a particular set of institutional arrangements and a coordinating mechanism for producing goods and services, to help it solve the economic problem. The economic system determines the answer to the questions above. The two extremes are laissez-faire capitalism and the command system. Systems in between are market systems or mixed economies.

Laissez-faire capitalism (or pure capitalism) is a system in which the government’s role is limited to protecting private property from theft and aggression, and establishing a legal environment in which contracts can be enforced and people can interact in markets to buy and sell goods, services, and resources. No society has ever employed a true laissez-faire system.

The command system is an economic system in which most property resources are owned by the government and economic decisions are made by a central government body. This is also called socialism or communism. Few countries now use a command system.

Most economies use a market system (capitalism or a mixed economy), an economic system in which property resources are privately owned, and markets and prices are used to direct and coordinate economic activities. Compared to laissez-faire capitalism, government plays a bigger role, but the market is still dominant.

Characteristics of the market system

Key features of a market economy:
- Private property
- Freedom of enterprise and choice
- Self-interest
Private property is the right of private persons and firms to obtain, own, control, employ, dispose of, and bequeath land, capital, and other property. The existence of property rights encourages investment, innovation, and economic growth. Property rights ensure that only mutually beneficial exchanges take place.

Freedom of enterprise is the freedom of firms to obtain economic resources, to use these resources to produce products of the firm’s own choosing, and to sell their products in markets of their choice.

Freedom of choice is the freedom of owners of property resources to employ or dispose of them as they see fit, and of consumers to spend their incomes in a manner that they think is appropriate.

Self-interest is that which each firm, property owner, worker, and consumer believes is best for itself. Self-interest allows each economic actor to try to achieve his or her own goals.

Competition is the presence in a market of a large number of independent buyers and sellers competing with one another, and the freedom of buyers and sellers to enter and leave the market. Competition means that no one buyer or seller can set prices, and it also means that industries can adjust automatically when demand rises or falls.

Markets and prices allow the market system to coordinate demand and supply of millions of goods and services.

A market is any institution or mechanism that brings together buyers and sellers of particular goods, services, or resources for the purpose of exchange.

The market system encourages technological change and the use of sophisticated capital goods in order to produce output.

Specialization refers to the use of the resources of an individual, a firm, a region, or a nation to produce one or a few goods and services. Most people produce only one good or service and use the proceeds to buy all the goods and services they consume.

One method of specialization is the division of labour, which refers to dividing the work required to produce a product into a number of different tasks that are performed by different workers. This makes use of differences in ability, fosters learning by doing, and saves time.
Another method of specialization is regional or international, with blueberries produced in Nova Scotia traded for wheat produced in Saskatchewan or bananas produced in Costa Rica.

Money is used in a market system. Money, any item that is generally acceptable to sellers in exchange for goods and services, serves as a *medium of exchange*, an item sellers generally accept and buyers generally use to pay for a good or service. The use of money avoids the transaction costs of *barter*, the exchange of one good or service for another good or service.

Finally, government plays an active, but limited, role in a market economy. One role for government is to address market failures.

**Five fundamental questions**

- What goods and services will be produced?
- How will the goods and services be produced?
- Who will get the goods and services?
- How will the system accommodate change?
- How will the system promote progress?

**What goods and services will be produced?**

The goods and services that can be produced at a profit will be produced; the goods and services that can only be produced at a loss will not be produced. Profit = total revenue – total cost, so if total revenue > total cost, more will be produced, the industry will expand, and resources will move towards that industry. If total revenue < total cost, less will be produced, the industry will contract, and resources will move away from that industry.

Consumers are in command and “vote” with their dollars. *Consumer sovereignty* is the determination by consumers of the types and quantities of goods and services that will be produced with the scarce resources of the economy. *Dollar votes* are the “votes” that consumers and entrepreneurs cast for the production of consumer and capital goods, respectively, when they purchase them in product and resource markets. These votes determine which products and industries will survive.

**How will the goods and services be produced?**

The combinations of resources and technologies that minimize the cost per unit of output will be used to produce goods and services. Lower costs allow for lower prices, which lead to a higher market share for those producers. The most efficient production technique depends on the available technology and on the prices of the needed resources.

**Who will get the goods and services?**

Consumers with the ability and willingness to pay the market price will get the product. Ability to pay depends on income, and willingness to pay depends on preferences.
How will the system accommodate change?

Changes in consumer tastes are communicated to producers through changes in spending, and result in changes to prices and then in changes to output.

The guiding function of prices is the ability of price changes to bring about changes in the quantities of products and resources demanded and supplied.

How will the system promote progress?

Technological advance and capital accumulation both contribute to a higher standard of living.

Technological advance refers to new and better goods and services, and new and better ways of producing or distributing them. The market system provides incentives for technological change in the form of market share, revenue, and profit.

Rival firms must adopt the technologies of the most advanced firms or else face creative destruction, the hypothesis that the creation of new products and production methods simultaneously destroys the market power of firms that are wedded to existing products and older ways of doing business.

The invisible hand

Adam Smith, in his 1776 book *The Wealth of Nations*, wrote that the firms, by seeking their own best interest, will lead to what is in the public’s best interest through the invisible hand, the tendency of firms and resource suppliers seeking to further their own self-interest in competitive markets to also promote the interest of society as a whole. Prices communicate information about scarcity and value; competition forces producers and resource suppliers to respond; and firms, acting in their own best interest, also promote society’s interests in terms of efficiency.

Three special merits of the market system:
- Efficiency through producing what society wants.
- Incentives to acquire skills and to innovate.
- Freedom to pursue one’s own self-interest.

The demise of the command system

The coordination problem meant that central planners had to coordinate all of the millions of decisions by economic agents. If one link in the chain broke, then there was a chain reaction throughout the economy.

The incentive problem meant that managers had no reason to respond to shortages or surpluses of goods by adjusting production. There was also a lack of entrepreneurship due to the lack of a profit motive.

The circular flow model
The *circular flow diagram* is a depiction of the flows of resources from households to firms and of products from firms to households. These flows are accompanied by reverse flows of money from firms to households and from households to firms.

**Factor Market**

- _______ sell
- _______ buy

**Businesses**

- sell _____
- buy _____

**Households**

- sell _____
- buy _____

**Product Market**

- _______ sell
- _______ buy

A *household* refers to one or more persons occupying a housing unit, who buy businesses’ goods and services in the product market using income derived from selling resources in the factor market.

A *business* is an economic entity (firm) that purchases factors of production and provides goods and services to the economy.

A *sole proprietorship* is an unincorporated firm owned and operated by one person.

A *partnership* is an unincorporated firm owned and operated by two or more people.

A *corporation* is a legal entity chartered by the federal or provincial government that operates as a distinct and separate body from the individuals who own it.

The *product market* refers to the market in which products are sold by firms and bought by households.

The *factor market* is the market in which households sell and firms buy factors of production.

**How the market system deals with risk**

The market system manages risk by allowing business owners to accept the financial consequences (good or bad) of their decisions. Business owners are guided by the profit system. Employees and suppliers are shielded from risk; this allows businesses to attract inputs.