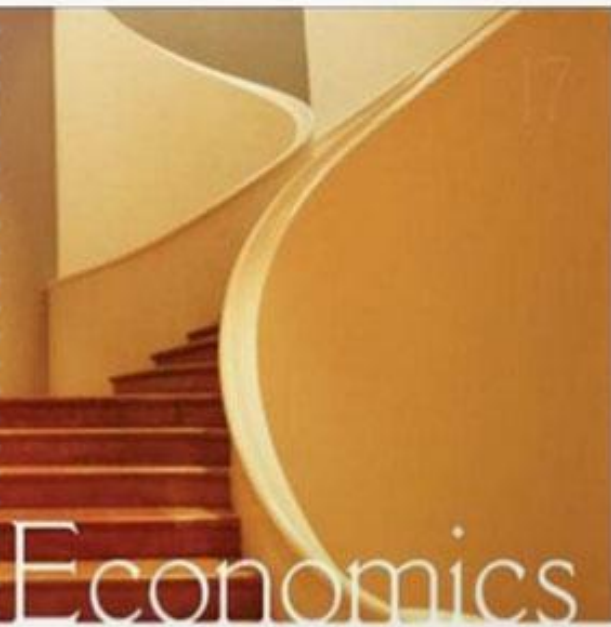


SOLUTIONS MANUAL



Economics

McConnell
Brue

CHAPTER TWO 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.

WHAT'S NEW

This chapter combines Chapter 4 from the 16th edition with the last part of chapter 2 (the part not moved to chapter 1). The result is an overview of the market system that better prepares students for the discussion of demand and supply in Chapter 3.

Discussion of the market system has been condensed, streamlined for readability without loss of essential content.

The term "roundabout production" has been eliminated as it is no longer widely used.

The "four fundamental questions" are now the "five fundamental questions," adding the question, "How will the system promote progress?" This discussion has also been condensed.

A new section on the demise of command systems has been added. This draws on material from Web Chapter 39 on Russia and China from the 16th edition. (Note that Web Chapter 39 is not part of this edition.)

The "Global Perspective" on economic freedom has been updated.

A brief new "Consider This" box called "Buy American" has been added.

There have been minor revisions to the study questions, including the addition of a new question.

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.

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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.
14. Differentiate between product and resource markets.
15. Define and identify terms and concepts listed at the end of the chapter.

COMMENTS AND TEACHING SUGGESTIONS

1. A surprising number of students do not really understand the characteristics of the American market system. Many students have no idea how prices are set and even after the chapter on supply and demand may still believe that most prices are determined by an external government agency or by producers arbitrarily.
2. In discussing the importance of private property, you may want to use the following Concept Illustration.

Concept Illustration – The “Berry Bikes” and Private Property

The following excerpt illustrates the importance of personal property rights to the “care and maintenance” of property. Where no such rights exist, property tends to get overused and abused.

The “Berry Bikes”: A Lesson in Private Property¹

Berry College is a private college located on a large campus adjacent to Rome, Georgia. In March 1998, the Berry College Student Government Association (SGA) used student activity funds to purchase 20 bicycles for student use on campus.

The bright red bicycles, each with an identifying plate reading, “Berry Bike,” were available to all students on a “first-come, first-served basis,” making them a common property resource. The rationale for spending student fees was that the distance between some buildings on campus made getting to class on time difficult. Several factors would seem to favor the plan. The campus is relatively self-contained; it is unlikely that townspeople would enter college property to use the bikes or that students would ride them off campus where they would be abandoned, lost, or stolen.

Moreover, the student body is relatively small. Anyone who abused a bicycle could be readily identified, and the students harmed by having bicycles mistreated would not be strangers. These factors would presumably deter would-be vandals.

Unfortunately, the results of the Berry bike project were dismal. It took little time for the misuse of the bicycles to become evident. Writing in the April 2, 1998, *Campus Carrier*, student Liz Hill reported that “Chains have been broken, tires punctured, handlebars bent, and seats torn” after “only a couple of weeks.” Recognizing the underlying cause of mistreatment, Hill implored

¹ This anecdote is abridged from Daniel L. Alban and E. Frank Stephenson, “The ‘Berry Bikes:’ A Lesson in Private Property,” *The Freeman*, October 1999, p 8-9. Reprinted with permission.

students to “treat the bikes as if they were your own property.” Evidently, her column spurred little change.

On April 21, SGA President M. Lynsey Morris e-mailed all students that “It has come to our attention here in the SGA office that many students are failing to take care of the Berry Bikes.... These bicycles are top quality and should not be bending and breaking the way they are. The [SGA] officers and other students have seen many people riding the bikes at absurd speeds, doing tricks, and just abusing the bicycles in general.” She too requested that students “treat [the bikes] as you would your personal property.” Morris’s appeal [also] apparently met with little success; a survey at the end of the semester revealed that four of the 20 bikes were lost or stolen and 11 were in a state of disrepair.

Undeterred, the SGA had the bicycles repaired over the summer recess and resumed the program in the fall. It soon became apparent that the abuse would continue. The September 10 *Campus Carrier* editorialized about “mangled corpses of twisted red metal that lie about campus” and concluded that “Perhaps SGA put too much trust in human nature and Berry students’ respect for property.” Was that the problem? Or was it that the SGA did not understand the role of incentives? Only a month into the new semester, the SGA suspended the program with the intention of leasing the remaining bicycles to students on a semester-by-semester basis, thereby alleviating the problems associated with common-property resources.

3. If you haven’t already talked about Adam Smith and his role in economics, this may be a good time to introduce the “father of economics.” His emphasis on the role of self-interest in motivating economic activity is especially relevant here. You might place copies of the “Wealth of Nations” on reserve at the library to encourage students to sample the original work. You could use short excerpts as the basis for discussion or essays. “Adam Smith and the Wealth of Nations,” a 28-minute video/film, is an excellent supplement. Check with your Federal Reserve District Bank’s public information office or your nearest Center for Economic Education for availability.
4. Markets coordinate economic activity and changes in prices (products and resources) signal that changes have occurred within particular markets. A simple example of product X and product Y can be used. Assume an increase in the demand for X. This change will lead to an increase in the price of X, an increase in the profitability of X, an increase in the quantity supplied of X, an increase in the demand for the resources used to produce X, and an increase in the prices of the those resources. Because of a limit in consumer income, the demand for Y is assumed to decrease followed by all of the changes that will occur in response to the decrease in the demand of Y. After all of these changes have occurred, explain how the transferable resources will move from Y to X. This illustrates the concepts of the “invisible hand.”
5. This is a good time to reintroduce the concept of goods for the future from chapter 1. In discussing the importance of producing goods for the future for the market system, remind the students of the impact upon the production of consumption goods in the present.
6. In discussing the use of money, the following Concept Illustration may be useful.

Imagine a worker producing alternators for automobiles. At the end of the week, instead of receiving a piece of paper signed by the company, or a few pieces of paper engraved in green and black, the worker’s pay consists of ten alternators. With no desire to hoard alternators, the worker ventures into the business district to spend this income on groceries, clothing, and a movie. Obviously, the worker is faced with some inconvenient and time-consuming trading, and may not be able to negotiate any exchanges at all. Finding an owner of a clothing store who needs an alternator can be a formidable task. And if the clothing does not trade evenly for the alternators, how do the parties “make change”?

It is fair to say that money is one of the great social inventions of civilization.

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7. The five fundamental questions must be answered by all types of economic systems. Although the emphasis of this chapter is on the American market system, current economic changes in Russia and China and areas of the developing world can be discussed to illustrate how different types of economics answer these questions differently. Students tend to be fascinated with the contrasts between the former Soviet and American systems; the contrasts seem to make students more aware of aspects of capitalism that may have been taken for granted. In any case the instructor may want to supplement the chapter by assigning students to find current news items on the economies of the transitional economic systems of the former Eastern bloc countries. This helps to point out that the economizing problem and five fundamental questions are common to all societies, not just to capitalist systems
8. The “Consider This” box on McDonald’s product innovations that have thrived or failed is an effective way to reinforce consumer sovereignty and its importance to the question of “What will be produced?”
9. When discussing the first two of the fundamental questions, ask who in the market economy are most responsible for answering each of the questions. Explain that the “Who will get the output?” question is an income distribution question and is determined by the distribution and productivity of the resources and the demand for the resources. Discuss how differing consumer dollar votes in the market for fast food workers and computer system workers determine the differences in the workers’ wages and incomes.

STUDENT STUMBLING BLOCK

This chapter introduces students to many important concepts and terms that will be expanded upon in later chapters. These concepts and terms are vital to the understanding of economics. Current event examples can be helpful.

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.
- E. 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.

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- 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.

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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.

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- 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.

ANSWERS TO END-OF-CHAPTER QUESTIONS

- 2-1 Contrast how a market system and a command economy try to cope with economic scarcity.

A market system allows for the private ownership of resources and coordinates economic activity through market prices. Participants act in their own self-interest and seek to maximize satisfaction or profit through their own decisions regarding consumption or production. Goods and services are produced and resources are supplied by whoever is willing to do so. The result is competition and widely dispersed economic power.

The command economy is characterized by public ownership of nearly all property resources and economic decisions are made through central planning. The planning board, appointed by the government determines production goals for each enterprise. The division of output between capital and consumer goods is centrally decided based on the board's long-term priorities

- 2-2 How does self-interest help achieve society's economic goals? Why is there such a wide variety of desired goods and services in a market system? In what way are entrepreneurs and businesses at the helm of the economy but commanded by consumers?

The motive of self-interest gives direction and consistency to the economy. The primary driving force of the market system is self-interest. Entrepreneurs try to maximize their profits; property owners want the highest price for their resources; workers choose the job with the best wages, fringe benefits and working conditions. Consumers apportion their expenditures to maximize their utility, while seeking the lowest possible prices. As individuals express their free choice, the economy is directed to produce the most wanted goods at the lowest possible cost.

Each individual consumer will choose a variety of goods and services that in combination will maximize his/her satisfaction (utility). There is a wide variety because individual wants are diverse. To maximize profits, producers must respond to the desires of the individual consumer.

Although producers are free to choose what products they will produce, if the producers are to maximize profits, these good and services must be what consumers desire. Entrepreneurs can drive the economic ship where they want (at least for a while), but the ship will run aground (businesses will fail) if entrepreneurs at the helm don't listen to the consumers that command them.

- 2-3 Why are private property, and the protection of property rights, so critical to the success of the market system?

The ownership of private property and the protection of property rights encourages investment, innovation, and, therefore, economic growth. Property rights encourage the maintaining of the property and they facilitate the exchange of the property.

- 2-4 What are the advantages of using capital in the production process? What is meant by the term "division of labor"? What are the advantages of specialization in the use of human and material resources? Explain why exchange is the necessary consequence of specialization.

Capital goods enable producers to operate more efficiently and to produce more output.

“Division of labor” means that workers perform those tasks that are best suited to their individual abilities and skills.

The advantages of specialization for workers are that they can choose work according to their natural aptitudes, have the opportunity to perfect those skills, and save time in not having to shift continually from one task to another. Material resources will be developed and adapted for a specific use. On a regional basis, each region will produce those products for which it is best suited. By specializing in its comparative advantage, each region or set of human and material resources is being used to maximize efficiency.

When resources are specialized, they are no longer self-sufficient. To obtain the goods and services one needs, exchange is necessary. Also, specialization will result in a surplus of a specific good being produced. The surplus of one good will be exchanged for the surplus production of other goods.

- 2-5 What problem does barter entail? Indicate the economic significance of money as a medium of exchange. What is meant by the statement: “We want money only to part with it”?

Barter requires the “double coincidence of wants.” If someone wants something, he/she will have to find someone who wishes to part with that good and at the same time wishes to exchange the good for something that the first party wishes to part with.

With money as a medium of exchange, one knows the purchase price of the item to be purchased and its relative price to other items. Money is a very convenient common denominator, a common measure of value that is also used as a medium of exchange. Money also encourages specialization. Without money, workers and other resources could not be paid except in the output produced. All those who participated in the production of the good would have to collectively exchange it for all the goods and services desired by the resource owners.

Money itself has value only in relation to the resources, goods, and services that can be obtained with it. When people say that they want money, they really mean that they want the things that money can buy. In this sense, money imparts value only when someone parts with it.

- 2-6 Evaluate and explain the following statements:

- a. The market system is a profit-and-loss system.
 - b. Competition is the disciplinarian of the market economy.
- (a) The quotation is accurate. In a market system, producer decisions are motivated by the attempt to earn profits. Those products that enable a firm to earn at least a normal profit (minimum compensation for the entrepreneur for his/her time and talents) will be produced. If the product cannot be produced for a profit—in other words, if losses are involved in production—the capitalist firm will respond by seeking lower cost production methods and may halt the production of goods completely. Because profits and/or losses are the motivation behind the fundamental decisions made in a market system, it could be called a “profit and loss economy.”
- (b) Competition provides discipline in two ways. First, it forces firms to seek the least-cost production methods or face being driven out of business by their rivals. Second, it prevents successful producers from charging whatever the market will bear. Competition keeps prices at a level where total revenue will just cover the total cost of production including a normal profit, but no more in the long run. If sellers try to charge a price that will earn them economic profits, new firms will enter the industry, increasing supply, and lowering prices until the economic profits are eliminated. Competition is indispensable in this role, because otherwise some other method would have to be found to direct firms to use the least-cost production technique and to charge a price that provides only a normal return. Where

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competition does not exist, such as in natural monopolies like public utility companies, regulators or publicly owned companies must assume the role of disciplinarian. Experience has shown that this is a difficult process and does not achieve the same results as easily as a competitive market situation.

- 2-7 In the 1990s thousands of “dot-com” companies emerged with great fanfare to take advantage of the Internet and new information technologies. A few, like Yahoo, eBay, and Amazon, generally thrived and prospered, but many others struggled and eventually failed. Explain these varied outcomes in terms of how the market system answers the question “What goods and services will be produced?”

The expectation of economic profits lured many new firms into the “dot-com” industries. However, because of a lack of information and a market unable to sustain so many firms, many failed to realize even a normal profit and failed. [Technically many of the early dot-coms were not earning economic profits, but their shareholders were reaping huge windfalls from the stock market speculation.] When these new firms found that they could not profitably produce in this industry, they dropped out and the industry declined. The problem was not so much one of consumer sovereignty – consumers demonstrated an interest in these services. The heavy competition of so many firms trying to establish themselves in the market led to prices that were insufficient to cover economic costs. In a few cases, most notably Napster (an internet company that allowed users to download music at little or no cost), government restrictions on activities (copyright infringement in Napster’s case) led to firm failure (at least for a time).

- 2-8 With current technology, suppose a firm is producing 400 loaves of banana bread daily. Also, assume that the least-cost combination of resources in producing those loaves is 5 units of labor, 7 units of land, 2 units of capital, and 1 unit of entrepreneurial ability, selling at prices of \$40, \$60, \$60, and \$20, respectively. If the firm can sell these 400 units at \$2 per unit, will it continue to produce banana bread? If this firm’s situation is typical for the other makers of banana bread, will resources flow to or away from this bakery good?

The firm will continue to produce as it is earning economic profits of \$40 (Total revenue of \$800 minus total cost of \$760). If this firm is typical, more resources will flow toward banana bread as other potential firms are attracted to the economic profits.

- 2-9 (*Key Question*) Assume that a business firm finds that its profit is greatest when it produces \$40 worth of product A. Suppose also that each of the three techniques shown in the table on page 43 will produce the desired output.

Resource	Price per unit of resource	Resource Units Required		
		Technique 1	Technique 2	Technique 3
Labor	\$3	5	2	3
Land	4	2	4	2
Capital	2	2	4	5
Entrepreneurial ability	2	4	2	4

- a. With the resource prices shown, which technique will the firm choose? Why? Will production entail profit or losses? What will be the amount of profit or loss? Will the industry expand or contract? When will that expansion end?

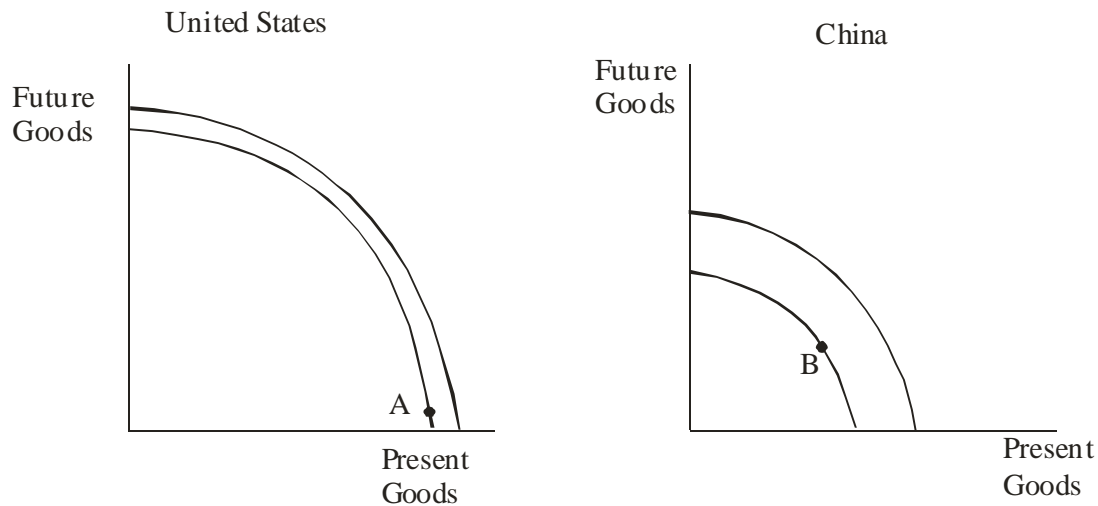
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- b. Assume now that a new technique, technique 4, is developed. It combines 2 units of labor, 2 of land, 6 of capital, and 3 of entrepreneurial ability. In view of the resource prices in the table, will the firm adopt the new technique? Explain your answer.
- c. Suppose that an increase in labor supply causes the price of labor to fall to \$1.50 per unit, all other resource prices being unchanged. Which technique will the producer now choose? Explain.
- d. “The market system causes the economy to conserve most in the use of those resources that are particularly scarce in supply. Resources that are scarcest relative to the demand for them have the highest prices. As a result, producers use these resources as sparingly as is possible.” Evaluate this statement. Does your answer to part c, above, bear out this contention? Explain.
- (a) Technique 2. Because it produces the output with least cost (\$34 compared to \$35 each for the other two). Economic profit will be \$6 (= 40 - \$34), which will cause the industry to expand. Expansion will continue until prices decline to where total revenue is \$34 (equal to total cost).
- (b) Adopt technique 4 because its cost is now lowest at \$32.
- (c) Technique 1 because its cost is now lowest at \$27.50.
- (d) The statement is logical. Increasing scarcity causes prices to rise. Firms ignoring higher resource prices will become high-cost producers and be competed out of business by firms switching to the less expensive inputs. The market system forces producers to conserve on the use of highly scarce resources. Question 9c confirms this: Technique 1 was adopted because labor had become less expensive.
- 2-10 (*Key Question*) Some large hardware stores such as Home Depot boast of carrying as many as 20,000 different products in each store. What motivated the producers of those individuals to make them and offer them for sale? How did producers decide on the best combinations of resources to use? Who made these resources available, and why? Who decides whether these particular hardware products should continue to be produced and offered for sale?
- The quest for profit led firms to produce these goods. Producers looked for and found the least-cost combination of resources in producing their output. Resource suppliers, seeking income, made these resources available. Consumers, through their dollar votes, ultimately decide on what will continue to be produced.
- 2-11 What is meant by the term “creative destruction”? How does the emergence of MP3 (iPod) technology relate to this idea?
- Creative destruction refers to the process by which the creation of new products and production techniques destroys the market positions of firms committed to producing only existing products or using outdated methods. The ability to download and store a large number of songs, and the superior quality of MP3 is causing a decline in the CD industry, just as CDs once replaced cassette tapes, which had previously replaced phonographs (records).
- 2-12 In a sentence, describe the meaning of the phrase “invisible hand.”
- Market prices act as an “invisible hand,” coordinating an economy by rationing what is scarce, and providing incentives to produce the most desired goods and services.
- 2-13 In market economies, firms rarely worry about the availability of inputs to produce their products, whereas in command economies input availability is a constant concern. Why the difference?

The Market System and the Circular Flow

In market economies, buyers of inputs know that sellers want to make resources available for sale because that is how they earn their profits. If there aren't enough resources available, prices will rise until suppliers come forth with the desired amounts. In command economies the availability of inputs depends on what was specified in the plan, and how well the plan was executed. There is no opportunity (at least not legally) to offer greater payments to get those resources provided.

- 2-14 (*Key Question*) On average, households in China save 40% of their annual income each year, whereas households in the United States save less than 5%. Production possibilities are growing at roughly 9 percent annually in China and 3.5 percent in the United States. Use graphical analysis of “present goods” versus “future goods” to explain the differences in growth rates.



- 2-15 Distinguish between the resource market and product market in the circular flow model. In what way are businesses and households both *sellers* and *buyers* in this model? What are the flows in the circular flow model?

The resource markets are where the owners of the resources (the households) sell their resources to the buyers of the resources (businesses). In the product markets, businesses sell the goods and services they have produced to the buyers of the goods and services, the households.

Households (individuals) either own all economic resources directly or own them indirectly through their ownership of business corporations. These households are willing to sell their resources to businesses because attractive prices draw them into specific resource markets. Businesses buy resources because they are necessary for producing goods and services. The interaction of the buyers and sellers establishes the price of each resource.

In the product market, businesses are the sellers and householders are the buyers; their role in the market has been reversed. Each group of economic units both buys and sells.

One flow is the flow of real goods and services (including resource services) and the other flow is the flow of money (money income, consumption expenditures, revenue, production costs).