

IN THIS CHAPTER YOU WILL LEARN:

- The definition of economics and the features of the economic perspective.
- The role of economic theory in economics.
- The distinction between microeconomics and macroeconomics.
- The categories of scarce resources and the nature of the economizing problem.
- About production possibilities analysis, increasing opportunity costs, and economic growth.

## Limits, Alternatives, and Choices

***(An appendix on understanding graphs follows this chapter. If you need a quick review of this mathematical tool, you might benefit by reading the appendix first.)*** People's wants are numerous and varied. Biologically, people need only air, water, food, clothing, and shelter. But in modern society people also desire goods and services that provide a more comfortable or affluent standard of living. We want bottled water, soft drinks, and fruit juices, not just water from the creek. We want salads, burgers, and pizzas, not just berries and nuts. We want jeans, suits, and coats, not just woven reeds. We want apartments, condominiums, or houses, not just mud huts. And, as the saying goes, "that is not the half of it." We also want DVD players, Internet service, education, homeland security, cell phones, health care, and much more.

Fortunately, society possesses productive resources, such as labor and managerial talent, tools and machinery, and land and mineral deposits. These resources, employed in the economic system (or simply the economy), help us produce goods and services that satisfy many of our economic



**O 1.1**  
Origin of the term  
"Economics"

wants. But the blunt reality is that our economic wants far exceed the productive capacity of our scarce (limited) resources. We are forced to make choices. This unyielding truth underlies the definition of **economics**, which is the social science concerned with how individuals, institutions, and society make optimal (best) choices under conditions of scarcity.

## The Economic Perspective

Economists view things from a unique perspective. This **economic perspective**, or economic way of thinking, has several critical and closely interrelated features.

### Scarcity and Choice

From our definition of economics, we can easily see why economists view the world through the lens of scarcity. Scarce economic resources mean limited goods and ser-

vices. Scarcity restricts options and demands choices. Because we "can't have it all," we must decide what we will have and what we must forgo.

At the core of economics is the idea that "there is no free lunch." You may be treated to lunch, making it "free" from your perspective, but someone bears a cost—ultimately, society. Scarce inputs of land, equipment, farm labor, the labor of cooks and waiters, and managerial talent are required. Because society could have used these resources to produce something else, it sacrifices those other goods and services in making the lunch available. Economists call such sacrifices **opportunity costs**: To obtain more of one thing, society forgoes the opportunity of getting the next best thing. That sacrifice is the opportunity cost of the choice.

### CONSIDER THIS ...

**FREE ACCESSORY SET!**  
with the purchase  
of any of our pool tables\*  
**\$99.00 VALUE**  
Shipping & Handling \$3.95

\*Excludes the Premier pool table which comes with it's own accessory set

#### Free for All?

Free products are seemingly everywhere. Sellers offer free software, free cell phones, and free checking accounts. Dentists

give out free toothbrushes. At state visitor centers, there are free brochures and maps.

Does the presence of so many free products contradict the economist's assertion "There is no free lunch"? No! Resources are used to produce each of these products, and because those resources have alternative uses, society gives up something else to get the "free" good. Where resources are used to produce goods or services, there is no free lunch.

So why are these goods offered for free? In a word: marketing! Firms sometimes offer free products to entice people to try them, hoping they will then purchase those goods later. The free software may eventually entice you to buy the producer's upgraded software. In other instances, the free brochures contain advertising for shops and restaurants, and that free e-mail program is filled with ads. In still other cases, the product is free only in conjunction with a larger purchase. To get the free bottle of soda, you must buy the large pizza. To get the free cell phone, you need to sign up for a year's worth of cell phone service.

So "free" products may or may not be truly free to individuals. They are never free to society.

### Purposeful Behavior

Economics assumes that human behavior reflects "rational self-interest." Individuals look for and pursue opportunities to increase their **utility**—the pleasure, happiness, or satisfaction obtained from consuming a good or service. They allocate their time, energy, and money to maximize their satisfaction. Because they weigh costs and benefits, their economic decisions are "purposeful" or "rational," not "random" or "chaotic."



**O 1.2**  
Utility

Consumers are purposeful in deciding what goods and services to buy. Business firms are purposeful in deciding what products to produce and how to produce them. Government entities are purposeful in deciding what public services to provide and how to finance them.

"Purposeful behavior" does not assume that people and institutions are immune from faulty logic and therefore are perfect decision makers. They sometimes make mistakes. Nor does it mean that people's decisions are unaffected by emotion or the decisions of those around them. "Purposeful behavior" simply means that people make decisions with some desired outcome in mind.

Rational self-interest is not the same as selfishness. In the economy, increasing one's own wage, rent, interest, or

profit normally requires identifying and satisfying *somebody else's* wants! Also, people make personal sacrifices to others. They contribute time and money to charities because they derive pleasure from doing so. Parents help pay for their

### CONSIDER THIS ...



#### Fast-Food Lines

The economic perspective is useful in analyzing all sorts of behaviors. Consider an everyday example: the behavior of fast-

food customers. When customers enter the restaurant, they go to the shortest line, believing that line will minimize their time cost of obtaining food. They are acting purposefully; time is limited, and people prefer using it in some way other than standing in line.

If one fast-food line is temporarily shorter than other lines, some people will move to that line. These movers apparently view the time saving from the shorter line (marginal benefit) as exceeding the cost of moving from their present line (marginal cost). The line switching tends to equalize line lengths. No further movement of customers between lines occurs once all lines are about equal.

Fast-food customers face another cost-benefit decision when a clerk opens a new station at the counter. Should they move to the new station or stay put? Those who shift to the new line decide that the time saving from the move exceeds the extra cost of physically moving. In so deciding, customers must also consider just how quickly they can get to the new station compared with others who may be contemplating the same move. (Those who hesitate in this situation are lost!)

Customers at the fast-food establishment do not have perfect information when they select lines. Thus, not all decisions turn out as expected. For example, you might enter a short line and find someone in front of you is ordering hamburgers and fries for 40 people in the Greyhound bus parked out back (and the employee is a trainee)! Nevertheless, at the time you made your decision, you thought it was optimal.

Finally, customers must decide what food to order when they arrive at the counter. In making their choices, they again compare marginal costs and marginal benefits in attempting to obtain the greatest personal satisfaction for their expenditure.

Economists believe that what is true for the behavior of customers at fast-food restaurants is true for economic behavior in general. Faced with an array of choices, consumers, workers, and businesses rationally compare marginal costs and marginal benefits in making decisions.

children's education for the same reason. These self-interested, but unselfish, acts help maximize the givers' satisfaction as much as any personal purchase of goods or services. Self-interested behavior is simply behavior designed to increase personal satisfaction, however it may be derived.

## Marginal Analysis: Benefits and Costs

The economic perspective focuses largely on **marginal analysis**—comparisons of marginal benefits and marginal costs, usually for decision making. To economists, “marginal” means “extra,” “additional,” or “a change in.” Most choices or decisions involve changes in the status quo, meaning the existing state of affairs.

Should you attend school for another year? Should you study an extra hour for an exam? Should you supersize your fries? Similarly, should a business expand or reduce its output? Should government increase or decrease its funding for a missile defense system?

Each option involves marginal benefits and, because of scarce resources, marginal costs. In making choices rationally, the decision maker must compare those two amounts. Example: You and your fiancée are shopping for an engagement ring. Should you buy a  $\frac{1}{2}$ -carat diamond, a  $\frac{5}{8}$ -carat diamond, a  $\frac{3}{4}$ -carat diamond, a 1-carat diamond, or something even



O 1.3

Marginal analysis

larger? The marginal cost of a larger-size diamond is the added expense beyond the cost of the smaller-size diamond. The marginal benefit is the perceived lifetime pleasure (utility) from the larger-size stone. If the marginal benefit of the larger diamond exceeds its marginal cost (and you can afford it), buy the larger stone. But if the marginal cost is more than the marginal benefit, buy the smaller diamond instead, even if you can afford the larger stone!

In a world of scarcity, the decision to obtain the marginal benefit associated with some specific option always includes the marginal cost of forgoing something else. The money spent on the larger-size diamond means forgoing some other product. Opportunity costs are present whenever a decision is made. (Key Question 3)

## Theories, Principles, and Models

Like the physical and life sciences, as well as other social sciences, economics relies on the **scientific method**. That procedure consists of several elements:

- The observation of real-world behavior and outcomes.
- Based on those observations, the formulation of a possible explanation of cause and effect (hypothesis).

- The testing of this explanation by comparing the outcomes of specific events to the outcome predicted by the hypothesis.
- The acceptance, rejection, or modification of the hypothesis, based on these comparisons.
- The continued testing of the hypothesis against the facts. As favorable results accumulate, the hypothesis evolves into a theory. A very well-tested and widely accepted theory is referred to as an economic law or an **economic principle**—a statement about economic behavior or the economy that enables prediction of the probable effects of certain actions. Combinations of such laws or principles are incorporated into models, which are simplified representations of how something works, such as a market or segment of the economy.

Economists develop theories of the behavior of individuals (consumers, workers) and institutions (businesses, governments) engaged in the production, exchange, and consumption of goods and services. Theories, principles, and models are “purposeful simplifications.” The full scope of economic reality itself is too complex and bewildering to be understood as a whole. In developing theories, principles, and models economists remove the clutter and simplify.

Economic principles and models are highly useful in analyzing economic behavior and understanding how the economy operates. They are the tools for ascertaining cause and effect (or action and outcome) within the economic system. Good theories do a good job of explaining and predicting. They are supported by facts concerning how individuals and institutions actually behave in producing, exchanging, and consuming goods and services.

There are some other things you should know about economic principles.

- **Generalizations** Economic principles are generalizations relating to economic behavior or to the economy itself. Economic principles are expressed as the tendencies of typical or average consumers, workers, or business firms. For example, economists say that consumers buy more of a particular product when its price falls. Economists recognize that some consumers may increase their purchases by a large amount, others by a small amount, and a few not at all. This “price-quantity” principle, however, holds for the typical consumer and for consumers as a group.
- **Other-Things-Equal Assumption** In constructing their theories, economists use the *ceteris paribus* or **other-things-equal assumption**—the assumption

that factors other than those being considered do not change. They assume that all variables except those under immediate consideration are held constant for a particular analysis. For example, consider the relationship between the price of Pepsi and the amount of it purchased. Assume that of all the factors that might influence the amount of Pepsi purchased (for example, the price of Pepsi, the price of Coca-Cola, and consumer incomes and preferences), only the price of Pepsi varies. This is helpful because the economist can then focus on the “price of Pepsi–purchases of Pepsi” relationship without being confused by changes in other variables.



O 1.4

*Ceteris paribus*

- **Graphical Expression** Many economic models are expressed graphically. Be sure to read the special appendix at the end of this chapter as a review of graphs.

## Macroeconomics and Microeconomics

Economists develop economic principles and models at two levels.

### Macroeconomics

**Macroeconomics** examines either the economy as a whole or its basic subdivisions or aggregates, such as the government, household, and business sectors. An **aggregate** is a collection of specific economic units treated as if they were one unit. Therefore, we might lump together the millions of consumers in the U.S. economy and treat them as if they were one huge unit called “consumers.”

In using aggregates, macroeconomics seeks to obtain an overview, or general outline, of the structure of the economy and the relationships of its major aggregates. Macroeconomics speaks of such economic measures as total output, total employment, total income, aggregate expenditures, and the general level of prices in analyzing various economic problems. No or very little attention is given to specific units making up the various aggregates.

Figuratively, macroeconomics looks at the beach, not the pieces of sand, the rocks, and the shells.

### Microeconomics

**Microeconomics** is the part of economics concerned with individual units such as a person, a household, a firm, or an industry. At this level of analysis, the economist observes the details of an economic unit, or very small segment of

the economy, under a figurative microscope. In microeconomics we look at decision making by individual customers, workers, households, and business firms. We measure the price of a specific product, the number of workers employed by a single firm, the revenue or income of a particular firm or household, or the expenditures of a specific firm, government entity, or family. In microeconomics, we examine the sand, rock, and shells, not the beach.

The macro-micro distinction does not mean that economics is so highly compartmentalized that every topic can be readily labeled as either macro or micro; many topics and subdivisions of economics are rooted in both. Example: While the problem of unemployment is usually treated as a macroeconomic topic (because unemployment relates to aggregate production), economists recognize that the decisions made by *individual* workers on how long to search for jobs and the way *specific* labor markets encourage or impede hiring are also critical in determining the unemployment rate. (Key Question 5)

## Positive and Normative Economics

Both macroeconomics and microeconomics contain elements of positive economics and normative economics. **Positive economics** focuses on facts and cause-and-effect relationships. It includes description, theory development, and theory testing (theoretical economics). Positive economics avoids value judgments, tries to establish scientific statements about economic behavior, and deals with what the economy is actually like. Such scientific-based analysis is critical to good policy analysis.

Economic policy, on the other hand, involves **normative economics**, which incorporates value judgments about what the economy should be like or what particular policy actions should be recommended to achieve a desirable goal (policy economics). Normative economics looks at the desirability of certain aspects of the economy. It underlies expressions of support for particular economic policies.

Positive economics concerns *what is*, whereas normative economics embodies subjective feelings about *what ought to be*. Examples: Positive statement: "The unemployment rate in France is higher than that in the United States." Normative statement: "France ought to undertake policies to make its labor market more flexible to reduce unemployment rates." Whenever words such as "ought" or "should" appear in a sentence, you are very likely encountering a normative statement.

Most of the disagreement among economists involves normative, value-based policy questions. Of course, economists sometime disagree about which theories or models

best represent the economy and its parts; but they agree on a full range of economic principles. Most economic controversy thus reflects differing opinions or value judgments about what society should be like.

### QUICK REVIEW 1.1

- Economics examines how individuals, institutions, and society make choices under conditions of scarcity.
- The economic perspective stresses (a) resource scarcity and the necessity of making choices, (b) the assumption of rational behavior, and (c) comparisons of marginal benefit and marginal cost.
- Economists use the scientific method to establish economic theories—cause-effect generalizations about the economic behavior of individuals and institutions.
- Macroeconomics examines the economy as a whole; microeconomics focuses on specific units of the economy.
- Positive economics deals with factual statements ("what is"); normative economics involves value judgments ("what ought to be").

## Individuals' Economizing Problem

A close examination of the **economizing problem**—the need to make choices because economic wants exceed economic means—will enhance your understanding of economic models and the difference between microeconomic and macroeconomic analysis. Let's first build a microeconomic model of the economizing problem faced by an individual.

### Limited Income

We all have a finite amount of income, even the wealthiest among us. Even Donald Trump must decide how to spend his money! And the majority of us have much more limited means. Our income comes to us in the form of wages, interest, rent, and profit, although we may also receive money from government programs or family members. As Global Perspective 1.1 shows, the average income of Americans in 2004 was \$41,400. In the poorest nations, it was less than \$500.

### Unlimited Wants

For better or worse, most people have virtually unlimited wants. We desire various goods and services that provide utility. Our wants extend over a wide range of products, from *necessities* (for example, food, shelter, and clothing) to *luxuries* (for example, perfumes, yachts, and sports cars).



## GLOBAL PERSPECTIVE 1.1

## Average Income, Selected Nations

Average income (total income/population) and therefore typical individual budget constraints vary greatly among nations.

| Country       | Per Capita Income, 2004<br>(U.S. dollars, based on exchange rates) |
|---------------|--|
| Switzerland   | \$48,230   |
| United States | 41,400   |
| Japan         | 37,180   |
| France        | 30,090   |
| South Korea   | 13,980   |
| Mexico        | 6,770  |
| Brazil        | 3,890  |
| China         | 1,290  |
| Pakistan      | 600  |
| Nigeria       | 390  |
| Rwanda        | 220  |
| Liberia       | 110  |

Source: World Bank, [www.worldbank.org](http://www.worldbank.org).

Some wants such as basic food, clothing, and shelter have biological roots. Other wants, for example, specific kinds of food, clothing, and shelter, arise from the conventions and customs of society.

Over time, as new products are introduced, economic wants tend to change and multiply. Only recently have people wanted MP3 players, Internet service, digital cameras, or camera phones because those products did not exist a few decades ago. Also, the satisfaction of certain wants may trigger others: the acquisition of a Ford Focus or a Honda Civic has been known to whet the appetite for a Lexus or a Mercedes.

Services, as well as goods, satisfy our wants. Car repair work, the removal of an inflamed appendix, legal and accounting advice, and haircuts all satisfy human wants. Actually, we buy many goods, such as automobiles and washing machines, for the services they render. The differences between goods and services are often smaller than they appear to be.

For most people, the desires for goods and services cannot be fully satisfied. Bill Gates may have all that he wants for himself, but his massive charitable giving

suggests that he keenly wants better health care for the world's poor. Our desires for a particular good or service can be satisfied; over a short period of time we can surely get enough toothpaste or pasta. And one appendectomy is plenty. But our desire for goods and services in general seem to be another story.

Because we have only limited income (usually through our work) but seemingly insatiable wants, it is in our self-interest to economize: to pick and choose goods and services that create maximum utility.

## A Budget Line

We can clarify the economizing problem facing consumers by visualizing a **budget line** (or, more technically, a *budget constraint*). It is a schedule or curve that shows various combinations of two products a consumer can purchase with a specific money income. Although we assume two products, the analysis generalizes to the full range of products available to an individual consumer.

To understand the idea of a budget line, suppose that you received a Barnes & Noble (or Borders) gift card as a birthday present. The \$120 card is soon to expire. You take the card to the store and confine your purchase decisions to two alternatives: DVDs and paperback books. DVDs are \$20 each and paperback books are \$10 each. Your purchase options are shown in the table in Figure 1.1.

At one extreme, you might spend all of your \$120 "income" on 6 DVDs at \$20 each and have nothing left to spend on books. Or, by giving up 2 DVDs and thereby gaining \$40, you can have 4 DVDs at \$20 each and 4 books at \$10 each. And so on to the other extreme, at which you could buy 12 books at \$10 each, spending your entire gift card on books with nothing left to spend on DVDs.

The graph in Figure 1.1 shows the budget line. Note that the graph is not restricted to whole units of DVDs and books as is the table. Every point on the graph represents a possible combination of DVDs and books, including fractional quantities. The slope of the graphed budget line measures the ratio of the price of books ( $P_b$ ) to the price of DVDs ( $P_{dvd}$ ); more precisely, the slope is  $P_b/P_{dvd} = \$10/\$20 = -\frac{1}{2}$ , or  $-.5$ . So you must forgo 1 DVD (measured on the vertical axis) to buy 2 books (measured on the horizontal axis). This yields a slope of  $-\frac{1}{2}$  or  $-.5$ .

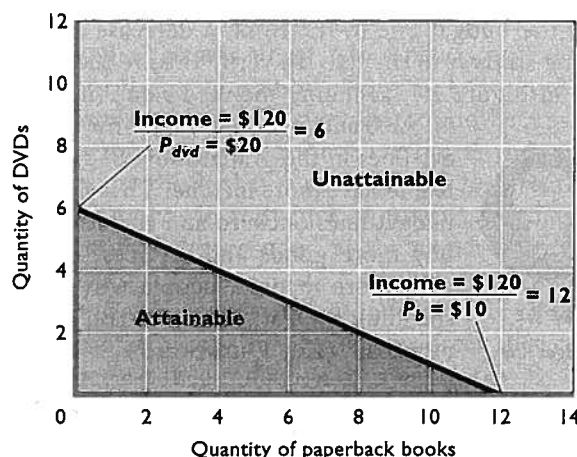
The budget line illustrates several ideas.

## Attainable and Unattainable Combinations

All the combinations of DVDs and books on or inside the budget line are *attainable* from the \$120 of money income. You can afford to buy, for example, 3 DVDs at \$20 each

**FIGURE 1.1 A consumer's budget line.** The budget line (or budget constraint) shows all the combinations of any two products that can be purchased, given the prices of the products and the consumer's money income.

| Units of DVDs<br>(Price = \$20) | Units of Books<br>(Price = \$10) | Total Expenditure        |
|---------------------------------|----------------------------------|--------------------------|
| 6                               | 0                                | $(\$120 = \$120 + \$0)$  |
| 5                               | 2                                | $(\$120 = \$100 + \$20)$ |
| 4                               | 4                                | $(\$120 = \$80 + \$40)$  |
| 3                               | 6                                | $(\$120 = \$60 + \$60)$  |
| 2                               | 8                                | $(\$120 = \$40 + \$80)$  |
| 1                               | 10                               | $(\$120 = \$20 + \$100)$ |
| 0                               | 12                               | $(\$120 = \$0 + \$120)$  |



and 6 books at \$10 each. You also can obviously afford to buy 2 DVDs and 5 books, if so desired, and not use up the value on the gift card. But to achieve maximum utility you will want to spend the full \$120.

In contrast, all combinations beyond the budget line are *unattainable*. The \$120 limit simply does not allow you to purchase, for example, 5 DVDs at \$20 each and 5 books at \$10 each. That \$150 expenditure would clearly exceed the \$120 limit. In Figure 1.1 the attainable combinations are on and within the budget line; the unattainable combinations are beyond the budget line.

**Tradeoffs and Opportunity Costs** The budget line in Figure 1.1 illustrates the idea of tradeoffs arising from limited income. To obtain more DVDs, you have



### O 1.5

Opportunity costs

to give up some books. For example, to obtain the first DVD, you trade off 2 books. So the opportunity cost of the first DVD is 2 books. To obtain the second DVD the opportunity cost is also 2 books. The straight-line budget constraint, with its constant slope, indicates constant opportunity cost. That is, the opportunity cost of 1 extra DVD remains the same ( $= 2$  books) as more DVDs are purchased. And, in reverse, the opportunity cost of 1 extra book does not change ( $= \frac{1}{2}$  DVD) as more books are bought.

**Choice** Limited income forces people to choose what to buy and what to forgo to fulfill wants. You will select the combination of DVDs and paperback books that you think is “best.” That is, you will evaluate your marginal benefits and marginal costs (here, product price) to make choices that maximize your satisfaction. Other people, with the same \$120 gift card, would undoubtedly make different choices.

## CONSIDER THIS ...



### Did Gates, Winfrey, and Rodriguez Make Bad Choices?

Opportunity costs come into play in decisions well beyond simple buying decisions. Consider the different choices people make with respect to college. College graduates usually earn about 50 percent more during their lifetimes than persons with just high

school diplomas. For most capable students, “Go to college, stay in college, and earn a degree” is very sound advice.

Yet Microsoft cofounder Bill Gates and talk show host Oprah Winfrey\* both dropped out of college, and baseball star Alex Rodriguez (“A-Rod”) never even bothered to start classes. What were they thinking? Unlike most students, Gates faced enormous opportunity costs for staying in college. He had a vision for his company, and his starting work young helped ensure Microsoft’s success. Similarly, Winfrey landed a spot in local television news when she was a teenager, eventually producing and starring in the *Oprah Winfrey Show* when she was 32 years old. Getting a degree in her twenties might have interrupted the string of successes that made her famous talk show possible. And Rodriguez knew that professional athletes have short careers. Therefore, going to college directly after high school would have taken away 4 years of his peak earning potential.

So Gates, Winfrey, and Rodriguez understood opportunity costs and made their choices accordingly. The size of opportunity costs greatly matters in making individual decisions.

\*Winfrey eventually went back to school and earned a degree from Tennessee State University when she was in her thirties.

**Income Changes** The location of the budget line varies with money income. An increase in money income shifts the budget line to the right; a decrease in money income shifts it to the left. To verify this, recalculate the table in Figure 1.1, assuming the card value (income) is



**W 1.1**  
Budget lines

(a) \$240 and (b) \$60, and plot the new budget lines in the graph. No wonder people like to have more income: That shifts their budget lines outward and enables them to buy more goods and services. But even with more income, people will still face spending tradeoffs, choices, and opportunity costs. (Key Question 7)

### QUICK REVIEW 1.2

- Because wants exceed incomes, individuals face an economizing problem; they must decide what to buy and what to forgo.
- A budget line (budget constraint) shows the various combinations of two goods that a consumer can purchase with a specific money income.
- Straight-line budget constraints imply constant opportunity costs associated with obtaining more of either of the two goods.

## Society's Economizing Problem

Society must also make choices under conditions of scarcity. It, too, faces an economizing problem. Should it devote more of its limited resources to the criminal justice system (police, courts, and prisons) or to education (teachers, books, and schools)? If it decides to devote more resources to both, what other goods and services does it forgo? Health care? Energy development?

## Scarce Resources

Society has limited or scarce **economic resources**, meaning all natural, human, and manufactured resources that go into the production of goods and services. This includes the entire set of factory and farm buildings and all the equipment, tools, and machinery used to produce manufactured goods and agricultural products; all transportation and communication facilities; all types of labor; and land and mineral resources.

## Resource Categories

Economists classify economic resources into four general categories.

**Land** Land means much more to the economist than it does to most people. To the economist **land** includes all natural resources ("gifts of nature") used in the production process, such as arable land, forests, mineral and oil deposits, and water resources.

**Labor** The resource **labor** consists of the physical and mental talents of individuals used in producing goods and services. The services of a logger, retail clerk, machinist, teacher, professional football player, and nuclear physicist all fall under the general heading "labor."

**Capital** For economists, **capital** (or capital goods) includes all manufactured aids used in producing consumer goods and services. Included are all factory, storage, transportation, and distribution facilities, as well as tools and machinery. Economists refer to the purchase of capital goods as **investment**.

Capital goods differ from consumer goods because consumer goods satisfy wants directly, whereas capital goods do so indirectly by aiding the production of consumer goods. Note that the term "capital" as used by economists refers not to money but to tools, machinery, and other productive equipment. Because money produces nothing, economists do not include it as an economic resource. Money (or money capital or financial capital) is simply a means for purchasing capital goods.

**Entrepreneurial Ability** Finally, there is the special human resource, distinct from labor, called **entrepreneurial ability**. The entrepreneur performs several functions:

- The entrepreneur takes the initiative in combining the resources of land, labor, and capital to produce a good or a service. Both a sparkplug and a catalyst, the entrepreneur is the driving force behind production and the agent who combines the other resources in what is hoped will be a successful business venture.
- The entrepreneur makes the strategic business decisions that set the course of an enterprise.
- The entrepreneur is an innovator. He or she commercializes new products, new production techniques, or even new forms of business organization.
- The entrepreneur is a risk bearer. The entrepreneur has no guarantee of profit. The reward for the entrepreneur's time, efforts, and abilities may be profits or losses. The entrepreneur risks not only his or her invested funds but those of associates and stockholders as well.

Because land, labor, capital, and entrepreneurial ability are combined to produce goods and services, they are called the **factors of production**, or simply “inputs.”

## Production Possibilities Model

Society uses its scarce resources to produce goods and services. The alternatives and choices it faces can best be understood through a macroeconomic model of production possibilities. To keep things simple, let’s initially assume:

- **Full employment** The economy is employing all its available resources.
- **Fixed resources** The quantity and quality of the factors of production are fixed.
- **Fixed technology** The state of technology (the methods used to produce output) is constant.
- **Two goods** The economy is producing only two goods: pizzas and industrial robots. Pizzas symbolize **consumer goods**, products that satisfy our wants directly; industrial robots (for example, the kind used to weld automobile frames) symbolize **capital goods**, products that satisfy our wants indirectly by making possible more efficient production of consumer goods.

## Production Possibilities Table

A production possibilities table lists the different combinations of two products that can be produced with a specific set of resources, assuming full employment. Table 1.1 presents a simple, hypothetical economy that is producing pizzas and industrial robots; the data are, of course, hypothetical. At alternative A, this economy would be devoting all its available resources to the production of industrial robots (capital goods); at alternative E, all resources would go to pizza production (consumer goods). Those alternatives are unrealistic extremes; an economy typically produces both capital goods and consumer goods, as in B, C, and D. As we move from alternative A to E, we increase the production of pizzas at the expense of the production of industrial robots.

**TABLE 1.1** Production Possibilities of Pizzas and Industrial Robots

| Type of Product               | Production Alternatives |   |   |   |   |
|-------------------------------|-------------------------|---|---|---|---|
|                               | A                       | B | C | D | E |
| Pizzas (in hundred thousands) | 0                       | 1 | 2 | 3 | 4 |
| Robots (in thousands)         | 10                      | 9 | 7 | 4 | 0 |

Because consumer goods satisfy our wants directly, any movement toward E looks tempting. In producing more pizzas, society increases the current satisfaction of its wants. But there is a cost: More pizzas means fewer industrial robots. This shift of resources to consumer goods catches up with society over time because the stock of capital goods does not expand at the current rate, with the result that some potential for greater future production is lost. By moving toward alternative E, society chooses “more now” at the expense of “much more later.”

By moving toward A, society chooses to forgo current consumption, thereby freeing up resources that can be used to increase the production of capital goods. By building up its stock of capital this way, society will have greater future production and, therefore, greater future consumption. By moving toward A, society is choosing “more later” at the cost of “less now.”

Generalization: At any point in time, a fully employed economy must sacrifice some of one good to obtain more of another good. Scarce resources prohibit such an economy from having more of both goods. Society must choose among alternatives. There is no such thing as a free pizza, or a free industrial robot.

## Production Possibilities Curve

The data presented in a production possibilities table are shown graphically as a **production possibilities curve**. Such a curve displays the different combinations of goods

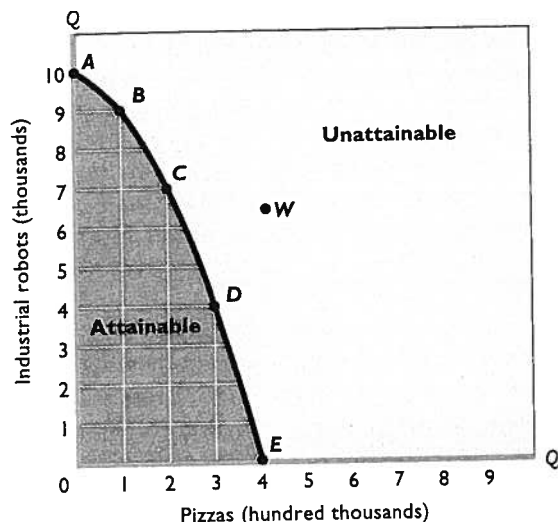


### G 1.1

Production possibilities curve

and services that society can produce in a fully employed economy, assuming a fixed availability of supplies of resources and constant technology. We arbitrarily represent the economy’s output of capital goods (here, industrial robots) on the vertical axis and the output of consumer goods (here, pizzas) on the horizontal axis, as shown in **Figure 1.2 (Key Graph)**.

Each point on the production possibilities curve represents some maximum output of the two products. The curve is a “constraint” because it shows the limit of attainable outputs. Points on the curve are attainable as long as the economy uses all its available resources. Points lying inside the curve are also attainable, but they reflect less total output and therefore are not as desirable as points on the curve. Points inside the curve imply that the economy could have more of both industrial robots and pizzas if it achieved full employment of its resources. Points lying beyond the production possibilities curve, like *W*, would represent a greater output than the output



**FIGURE 1.2 The production possibilities curve.** Each point on the production possibilities curve represents some maximum combination of two products that can be produced if resources are fully employed. When an economy is operating on the curve, more industrial robots means less pizzas, and vice versa. Limited resources and a fixed technology make any combination of industrial robots and pizzas lying outside the curve (such as at W) unattainable. Points inside the curve are attainable, but they indicate that full employment is not being realized.

## QUICK QUIZ 1.2

- Production possibilities curve *ABCDE* is bowed out from the origin because:
  - the marginal benefit of pizzas declines as more pizzas are consumed.
  - the curve gets steeper as we move from *E* to *A*.
  - it reflects the law of increasing opportunity costs.
  - resources are scarce.
- The marginal opportunity cost of the second unit of pizza is:
  - 2 units of robots.
  - 3 units of robots.
  - 7 units of robots.
  - 9 units of robots.
- The total opportunity cost of 7 units of robots is:
  - 1 unit of pizza.
  - 2 units of pizza.
  - 3 units of pizza.
  - 4 units of pizza.
- All points on this production possibilities curve necessarily represent:
  - society's optimal choice.
  - less than full use of resources.
  - unattainable levels of output.
  - full employment.

Answers: 1. c; 2. a; 3. b; 4. d

at any point on the curve. Such points, however, are unattainable with the current availability of resources and technology.

## Law of Increasing Opportunity Cost

Figure 1.2 clearly shows that more pizzas means fewer industrial robots. The number of units of industrial robots that must be given up to obtain another unit of pizzas, of course, is the opportunity cost of that unit of pizzas.

In moving from alternative A to alternative B in Table 1.1, the cost of 1 additional unit of pizzas is 1 fewer unit of industrial robots. But when additional units are considered—B to C, C to D, and D to E—an important

economic principle is revealed: For society, the opportunity cost of each additional unit of pizzas is greater than the opportunity cost of the preceding one. When we move from A to B, just 1 unit of industrial robots is sacrificed for 1 more unit of pizzas; but in going from B to C we sacrifice 2 additional units of industrial robots for 1 more unit of pizzas; then 3 more of industrial robots for 1 more of pizzas; and finally 4 for 1. Conversely, confirm that as we move from E to A, the cost of an additional unit of industrial robots (on average) is  $\frac{1}{4}$ ,  $\frac{1}{3}$ ,  $\frac{1}{2}$ , and 1 unit of pizzas, respectively, for the four successive moves.

Our example illustrates the **law of increasing opportunity costs**. As the production of a particular good increases, the opportunity cost of producing an additional unit rises.

**Shape of the Curve** The law of increasing opportunity costs is reflected in the shape of the production possibilities curve: The curve is bowed out from the origin of the graph. Figure 1.2 shows that when the economy moves from *A* to *E*, it must give up successively larger amounts of industrial robots (1, 2, 3, and 4) to acquire equal increments of pizzas (1, 1, 1, and 1). This is shown in the slope of the production possibilities curve, which becomes steeper as we move from *A* to *E*.

**Economic Rationale** The economic rationale for the law of increasing opportunity costs is that economic resources are not completely adaptable to alternative uses. Many resources are better at producing one type of good than at producing others. Some land is highly suited to growing the ingredients necessary for pizza production, but as pizza production expands society has to start using land that is less bountiful for farming. Other land is rich in mineral deposits and therefore well-suited to producing the materials needed to make industrial robots. As society steps up the production of robots, it must use land that is less and less adaptable to making their components.

If we start at *A* and move to *B* in Figure 1.2, we can shift resources whose productivity is relatively high in pizza production and low in industrial robots. But as we



**W 1.2**  
Production possibilities

move from *B* to *C*, *C* to *D*, and so on, resources highly productive of pizzas become increasingly scarce. To get more pizzas, resources whose productivity in industrial robots is relatively great will be needed. Increasingly more of such resources, and hence greater sacrifices of industrial robots, will be needed to achieve each 1-unit increase in pizzas. This lack of perfect flexibility, or interchangeability, on the part of resources is the

cause of increasing opportunity costs for society. (Key Question 10)

## Optimal Allocation

Of all the attainable combinations of pizzas and industrial robots on the curve in Figure 1.2, which is optimal (best)? That is, what specific quantities of resources should be allocated to pizzas and what specific quantities should be allocated to industrial robots in order to maximize satisfaction?

Recall that economic decisions center on comparisons of marginal benefit (MB) and marginal cost (MC). Any economic activity should be expanded as long as marginal benefit exceeds marginal cost and should be reduced if marginal cost exceeds marginal benefit. The optimal

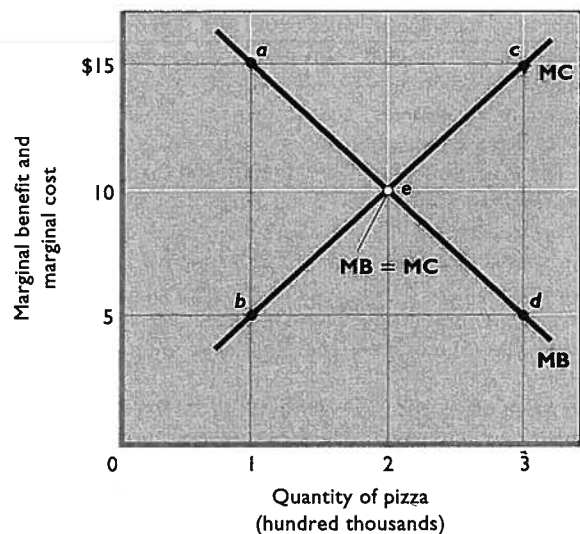
amount of the activity occurs where  $MB = MC$ . Society needs to make a similar assessment about its production decision.

Consider pizzas. We already know from the law of increasing opportunity costs that the marginal costs of additional units of pizzas will rise as more units are produced. We also know that we obtain extra or marginal benefits from additional units of pizzas. However, although economic wants in the aggregate are insatiable, the assumption that successive units of a particular product yield fewer additional benefits to society than prior units is reasonable.

The optimal quantity of pizza production is indicated by point *e* at the intersection of the MB and MC curves: 200,000 units in Figure 1.3. Why is this amount the optimal quantity? If only 100,000 units of pizzas were produced, the marginal benefit of an extra unit of them (point *a*) would exceed its marginal cost (point *b*). In money terms, MB is \$15, while MC is only \$5. When society gains something worth \$15 at a marginal cost of only \$5, it is better off. In Figure 1.3, net gains can continue to be realized until pizza-product production has been increased to 200,000.

In contrast, the production of 300,000 units of pizzas is excessive. There the MC of an added unit is \$15 (point *c*) and its MB is only \$5 (point *d*). This means that 1 unit of pizzas is worth only \$5 to society but costs it \$15 to obtain. This is a losing proposition for society!

**FIGURE 1.3 Optimal output:  $MB = MC$ .** Achieving the optimal output requires the expansion of a good's output until its marginal benefit (MB) and marginal cost (MC) are equal. No resources beyond that point should be allocated to the product. Here, optimal output occurs at point *e*, where 200,000 units of pizzas are produced.



So resources are being efficiently allocated to any product when the marginal benefit and marginal cost of its output are equal ( $MB = MC$ ). Suppose that by applying the same analysis to industrial robots, we find that the optimal ( $MB = MC$ ) output of robots is 7000. This would

mean that alternative *C* (200,000 units of pizzas and 7000 units of industrial robots) on the production possibilities curve in Figure 1.2 would be optimal for this economy. (Key Question 11)

### CONSIDER THIS ...



#### The Economics of War

Production possibilities analysis is helpful in assessing the costs and benefits of waging the broad war on terror-

ism, including the wars in Afghanistan and Iraq. An October 2005 estimate places the total cost of these efforts, including rebuilding expenses, at \$350 billion.

If we categorize all U.S. production as either “defense goods” or “civilian goods,” we can measure them on the axes of a production possibilities diagram such as that shown in Figure 1.2. The opportunity cost of using more resources for defense goods is the civilian goods sacrificed. In a fully employed economy, more defense goods are achieved at the opportunity cost of fewer civilian goods—health care, education, pollution control, personal computers, houses, and so on. The cost of war and defense is the other goods forgone. The benefits are numerous and diverse but clearly include the gains from protecting against future loss of American lives, assets, income, and well-being.

Society must assess the marginal benefit (*MB*) and marginal cost (*MC*) of additional defense goods to determine their optimal amounts—where to locate on the defense goods–civilian goods production possibilities curve. Although estimating marginal benefits and marginal costs is an imprecise art, the *MB-MC* framework is a useful way of approaching choices. An optimal allocation of resources requires that society expand production of defense goods until  $MB = MC$ .

The events of September 11, 2001, and the future threats they foreshadowed increased the marginal benefits of defense goods, as perceived by Americans. If we label the horizontal axis in Figure 1.3 “defense goods” and draw in a rightward shift of the *MB* curve, you will see that the optimal quantity of defense goods rises. In view of the concerns relating to September 11, the United States allocated more of its resources to defense. But the *MB-MC* analysis also reminds us we can spend too much on defense, as well as too little. The United States should not expand defense goods beyond the point where  $MB = MC$ . If it does, it will be sacrificing civilian goods of greater value than the defense goods obtained.

### QUICK REVIEW 1.3

- Economists categorize economic resources as land, labor, capital, and entrepreneurial ability.
- The production possibilities curve illustrates several ideas: (a) scarcity of resources is implied by the area of unattainable combinations of output lying outside the production possibilities curve; (b) choice among outputs is reflected in the variety of attainable combinations of goods lying along the curve; (c) opportunity cost is illustrated by the downward slope of the curve; (d) the law of increasing opportunity costs is implied by the bowed-outward shape of the curve.
- A comparison of marginal benefits and marginal costs is needed to determine the best or optimal output mix on a production possibilities curve.

## Unemployment, Growth, and the Future

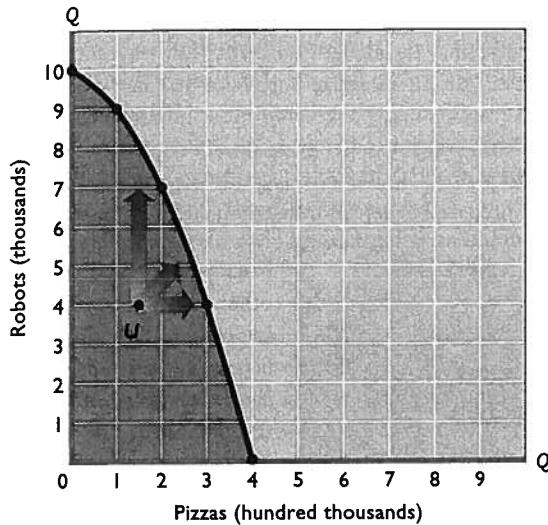
In the depths of the Great Depression of the 1930s, one-quarter of U.S. workers were unemployed and one-third of U.S. production capacity was idle. The United States has suffered a number of considerably milder downturns since then, the latest occurring in 2001. In that year total production fell one-half a percentage point and unemployment increased by about 2 million workers.

Almost all nations have experienced widespread unemployment and unused production capacity from business downturns at one time or another. Since 1995, for example, several nations—including Argentina, Japan, Mexico, Germany, and South Korea—have had economic downturns and unemployment.

How do these realities relate to the production possibilities model? Our analysis and conclusions change if we relax the assumption that all available resources are fully employed. The five alternatives in Table 1.1 represent maximum outputs; they illustrate the combinations of pizzas and industrial robots that can be produced when the economy is operating at full employment. With unemployment, this economy would produce less than each alternative shown in the table.

Graphically, we represent situations of unemployment by points inside the original production possibilities curve (reproduced here in Figure 1.4). Point *U* is one such point. Here the economy is falling short of the various maximum combinations of pizzas and industrial robots represented

**FIGURE 1.4 Unemployment and the production possibilities curve.** Any point inside the production possibilities curve, such as *U*, represents unemployment or a failure to achieve full employment. The arrows indicate that by realizing full employment, the economy could operate on the curve. This means it could produce more of one or both products than it is producing at point *U*.



by the points on the production possibilities curve. The arrows in Figure 1.4 indicate three possible paths back to full employment. A move toward full employment would yield a greater output of one or both products.

## A Growing Economy

When we drop the assumptions that the quantity and quality of resources and technology are fixed, the production possibilities curve shifts positions and the potential maximum output of the economy changes.

**Increases in Resource Supplies** Although resource supplies are fixed at any specific moment, they change over time. For example, a nation's growing population brings about increases in the supplies of labor and entrepreneurial ability. Also, labor quality usually improves over time. Historically, the economy's stock of capital has increased at a significant, though unsteady, rate. And although some of our energy and mineral resources are being depleted, new sources are also being discovered. The development of irrigation programs, for example, adds to the supply of arable land.

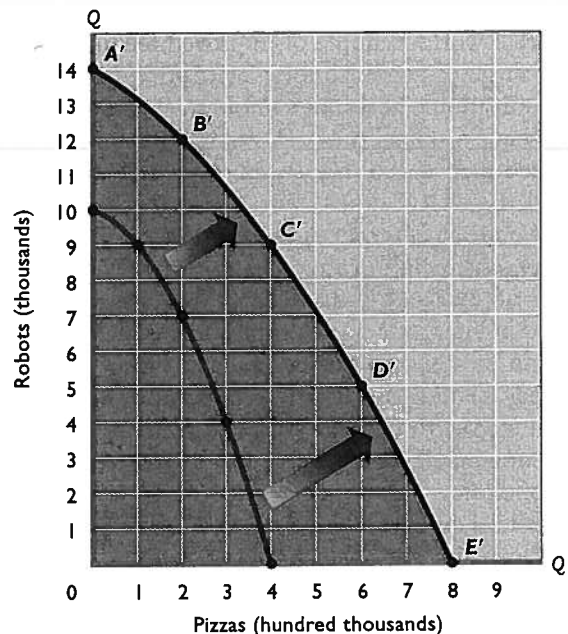
The net result of these increased supplies of the factors of production is the ability to produce more of both consumer goods and capital goods. Thus 20 years from now, the production possibilities may supersede those shown in Table 1.1. The new production possibilities might look like those in the table in Figure 1.5. The

greater abundance of resources will result in a greater potential output of one or both products at each alternative. The economy will have achieved economic growth in the form of expanded potential output. Thus, when an increase in the quantity or quality of resources occurs, the production possibilities curve shifts outward and to the right, as illustrated by the move from the inner curve to curve *A'B'C'D'E'* in Figure 1.5. This sort of shift represents growth of economic capacity, which, when used, means **economic growth**: a larger total output.

**Advances in Technology** An advancing technology brings both new and better goods and improved ways of producing them. For now, let's think of technological advance as being only improvements in the methods of production, for example, the introduction of computerized systems to manage inventories and schedule production. These advances alter our previous discussion of the economizing problem by allowing society to produce more goods with available resources. As with increases in

**FIGURE 1.5 Economic growth and the production possibilities curve.** The increase in supplies of resources, improvements in resource quality, and technological advances that occur in a dynamic economy move the production possibilities curve outward and to the right, allowing the economy to have larger quantities of both types of goods.

| Type of Product               | Production Alternatives |    |    |    |    |
|-------------------------------|-------------------------|----|----|----|----|
|                               | A'                      | B' | C' | D' | E' |
| Pizzas (in hundred thousands) | 0                       | 2  | 4  | 6  | 8  |
| Robots (in thousands)         | 14                      | 12 | 9  | 5  | 0  |



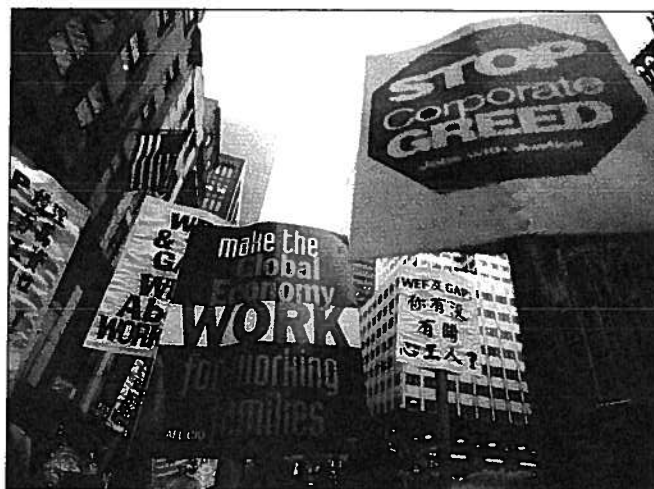
**Because they affect us so personally, we often have difficulty thinking accurately and objectively about economic issues.**

Here are some common pitfalls to avoid in successfully applying the economic perspective.

**Biases** Most people bring a bundle of biases and preconceptions to the field of economics. For example, some might think that corporate profits are excessive or that lending money is always superior to borrowing money. Others might believe that government is necessarily less efficient than businesses or that more government regulation is always better than less. Biases cloud thinking and interfere with objective analysis. All of us must be willing to shed biases and preconceptions that are not supported by facts.

**Loaded Terminology** The economic terminology used in

newspapers and broadcast media is sometimes emotionally biased, or loaded. The writer or spokesperson may have a cause to promote or an ax to grind and may slant comments accordingly. High profits may be labeled "obscene," low wages may be called "exploitive," or self-interested behavior may be "greed." Government workers may be referred to as "mindless bureaucrats" and those favoring stronger government regulations may be called "socialists." To objectively analyze economic issues, you must be prepared to reject or discount such terminology.



**Fallacy of Composition** Another pitfall in economic thinking is the assumption that what is true for one individual or part of a whole is necessarily true for a group of individuals or the whole. This is a logical fallacy called the *fallacy of composition*; the assumption is not correct. A statement that is valid for an individual or part is not necessarily valid for the larger group or whole. You may see the action better if you leap to your feet to see an

resource supplies, technological advances make possible the production of more industrial robots and more pizzas.

A real-world example of improved technology is the recent surge of new technologies relating to computers, communications, and biotechnology. Technological advances have dropped the prices of computers and greatly increased their speed. Improved software has greatly increased the everyday usefulness of computers. Cellular phones and the Internet have increased communications capacity, enhancing production and improving the efficiency of markets. Advances in biotechnology have resulted in important agricultural and medical discoveries. The sum of these new technologies is so significant that they may be contributing to greater-than-normal U.S. economic growth (larger rightward shifts of the nation's production possibilities curve).

**Conclusion:** Economic growth is the result of (1) increases in supplies of resources, (2) improvements in resource quality, and (3) technological advances. The consequence of growth is that a full-employment economy can enjoy a greater output of both consumption goods and

capital goods. Whereas static, no-growth economies must sacrifice some of one good to obtain more of another, dynamic, growing economies can have larger quantities of both goods. (Key Question 13)

### Present Choices and Future Possibilities

An economy's current choice of positions on its production possibilities curve helps determine the future location of that curve. Let's designate the two axes of the production possibilities curve as "goods for the future" and "goods for the present," as in Figure 1.6. Goods for the future are such things as capital goods, research and education, and preventive medicine. They increase the quantity and quality of property resources, enlarge the stock of technological information, and improve the quality of human resources. As we have already seen, goods for the future, such as capital goods, are the ingredients of economic growth. Goods for the present are consumer goods, such as food, clothing, and entertainment.

outstanding play at a football game. But if all the spectators leap to their feet at the same time, nobody—including you—will have a better view than when all remained seated.

Here is an economic example: An individual farmer who reaps a particularly large crop is likely to realize a sharp gain in income. But this statement cannot be generalized to farmers as a group. The individual farmer's large "bumper" crop will not noticeably reduce crop prices because each farmer produces a negligible fraction of the total farm output. But for all farmers as a group, prices decline when total output increases. Thus, if all farmers reap bumper crops, the total output of farm products will increase, depressing crop prices. If the price declines are relatively large, total farm income might actually fall.

**Post Hoc Fallacy** You must think very carefully before concluding that because event A precedes event B, A is the cause of B. This kind of faulty reasoning is known as the *post hoc, ergo propter hoc*, or "after this, therefore because of this," fallacy. Noneconomic example: A professional football team hires a new coach and the team's record improves. Is the new coach the cause? Maybe. Perhaps the presence of more experienced and talented players or an easier schedule is the true cause. The rooster crows before dawn, but does not cause the sunrise.

Economic example: Many people blamed the Great Depression of the 1930s on the stock market crash of 1929. But the crash did not cause the Great Depression. The same severe

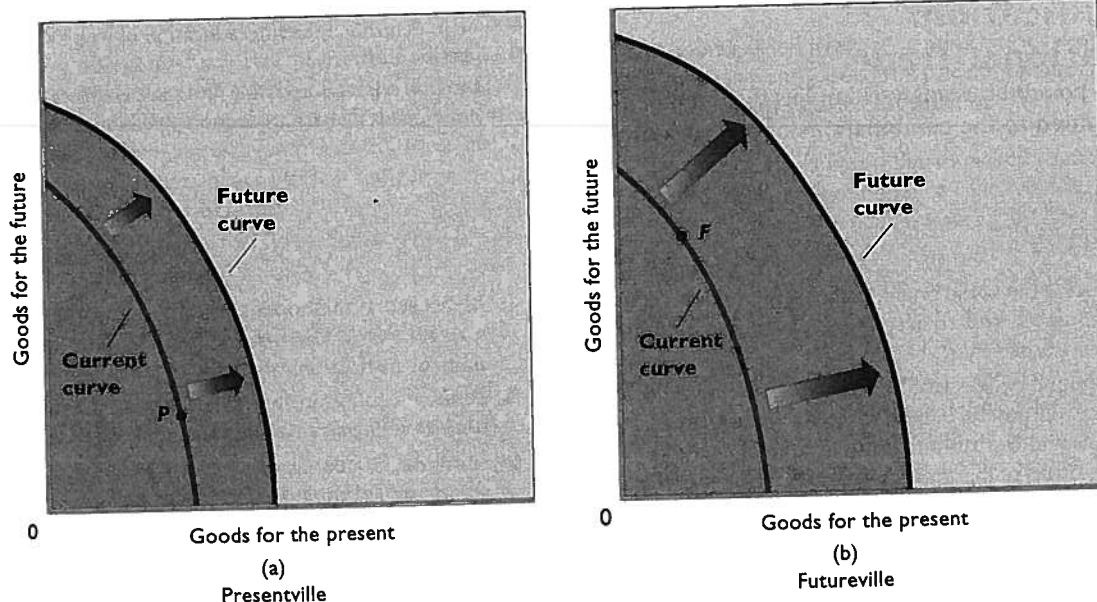
weaknesses in the economy that caused the crash caused the Great Depression. The depression would have occurred even without the preceding stock market crash.

**Correlation but not Causation** Do not confuse correlation, or connection, with causation. Correlation between two events or two sets of data indicates only that they are associated in some systematic and dependable way. For example, we may find that when variable  $X$  increases,  $Y$  also increases. But this correlation does not necessarily mean that there is causation—that an increase in  $X$  is the cause of an increase in  $Y$ . The relationship could be purely coincidental or dependent on some other factor,  $Z$ , not included in the analysis.

Here is an example: Economists have found a positive correlation between education and income. In general, people with more education earn higher incomes than those with less education. Common sense suggests education is the cause and higher incomes are the effect; more education implies a more knowledgeable and productive worker, and such workers receive larger salaries.

But might the relationship be explainable in other ways? Are education and income correlated because the characteristics required for succeeding in education—ability and motivation—are the same ones required to be a productive and highly paid worker? If so, then people with those traits will probably both obtain more education and earn higher incomes. But greater education will not be the sole cause of the higher income.

**FIGURE 1.6 Present choices and future locations of production possibilities curves.** A nation's current choice favoring "present goods," as made by Presentville in (a), will cause a modest outward shift of the production possibilities curve in the future. A nation's current choice favoring "future goods," as made by Futureville in (b), will result in a greater outward shift of the curve in the future.



Now suppose there are two hypothetical economies, Presentville and Futureville, which are initially identical in every respect except one: Presentville's current choice of positions on its production possibilities curve strongly favors present goods over future goods. Point *P* in Figure 1.6a indicates that choice. It is located quite far down the curve to the right, indicating a high priority for goods for the present, at the expense of fewer goods for the future. Futureville, in contrast, makes a current choice that stresses larger amounts of future goods and smaller amounts of present goods, as shown by point *F* in Figure 1.6b.



### G 1.2

Present choices  
and future  
possibilities

Now, other things equal, we can expect the future production possibilities curve of Futureville to be farther to the right than Presentville's curve. By currently choosing an output more favorable to technological advances and to increases in the quantity and quality of resources, Futureville will achieve greater economic growth than Presentville. In terms of capital goods, Futureville is choosing to make larger current additions to its "national factory" by devoting more of its current output to capital than Presentville. The payoff from this choice for Futureville is greater future production capacity and economic growth. The opportunity cost is fewer consumer goods in the present for Futureville to enjoy.

Is Futureville's choice thus necessarily "better" than Presentville's? That, we cannot say. The different outcomes simply reflect different preferences and priorities in the two countries. But each country will have to live with the economic consequences of its choice. (Key Question 14)

## A Qualification: International Trade

Production possibilities analysis implies that an individual nation is limited to the combinations of output indicated

by its production possibilities curve. But we must modify this principle when international specialization and trade exist.

You will see in later chapters that an economy can circumvent, through international specialization and trade, the output limits imposed by its domestic production possibilities curve. International specialization means directing domestic resources to output that a nation is highly efficient at producing. International trade involves the exchange of these goods for goods produced abroad. Specialization and trade enable a nation to get more of a desired good at less sacrifice of some other good. Rather than sacrifice 3 units of robots to get a third unit of pizza, as in Table 1.1, a nation might be able to obtain the third unit of pizza by trading only 2 units of robots for it. Specialization and trade have the same effect as having more and better resources or discovering improved production techniques; both increase the quantities of capital and consumer goods available to society. Expansion of domestic production possibilities and international trade are two separate routes for obtaining greater output.

### QUICK REVIEW 1.4

- Unemployment causes an economy to operate at a point inside its production possibilities curve.
- Increases in resource supplies, improvements in resource quality, and technological advance cause economic growth, which is depicted as an outward shift of the production possibilities curve.
- An economy's present choice of capital and consumer goods helps determine the future location of its production possibilities curve.
- International specialization and trade enable a nation to obtain more goods than its production possibilities curve indicates.

## Summary

1. Economics is the social science that examines how individuals, institutions, and society make optimal choices under conditions of scarcity.
2. The economic perspective includes three elements: scarcity and choice, purposeful behavior, and marginal analysis. It sees individuals and institutions making rational decisions based on comparisons of marginal costs and marginal benefits.
3. Economists employ the scientific method, in which they form and test hypotheses of cause-and-effect relationships to generate theories, laws, and principles. Economists often combine theories into representations called models.
4. Macroeconomics looks at the economy as a whole or its major aggregates. Microeconomics examines specific economic units or institutions.
5. Positive economic analysis deals with facts; normative economics reflects value judgments.
6. Individuals face an economizing problem. Because their wants exceed their income, they must decide what to purchase and what to forgo. Society also faces an economizing problem. Societal wants exceed the available resources necessary to fulfill them. Society therefore must decide what to produce and what to forgo.

# Graphs and Their Meaning

If you glance quickly through this text, you will find many graphs. Some seem simple, while others seem more formidable. All are included to help you visualize and understand economic relationships. Physicists and chemists sometimes illustrate their theories by building arrangements of multicolored wooden balls, representing protons, neutrons, and electrons, which are held in proper relation to one another by wires or sticks. Economists most often use graphs to illustrate their models. By understanding these "pictures," you can more readily comprehend economic relationships. Most of our principles or models explain relationships between just two sets of economic facts, which can be conveniently represented with two-dimensional graphs.

## Construction of a Graph

A *graph* is a visual representation of the relationship between two variables. The table in Figure 1 is a hypothetical illustration showing the relationship between income and consumption for the economy as a whole. Without even studying economics, we would expect intuitively that people would buy more goods and services when their incomes go up. Thus we are not surprised to find in the table that total consumption in the economy increases as total income increases.

The information in the table is expressed graphically in Figure 1. Here is how it is done: We want to show visually or graphically how consumption changes as income

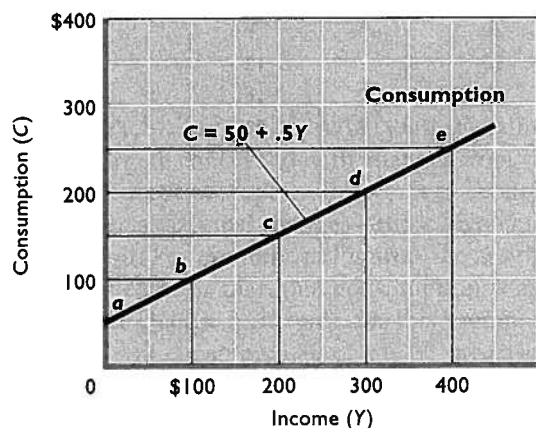
changes. Since income is the determining factor, we represent it on the **horizontal axis** of the graph, as is customary. And because consumption depends on income, we represent it on the **vertical axis** of the graph, as is also customary. Actually, what we are doing is representing the *independent variable* on the horizontal axis and the *dependent variable* on the vertical axis.

Now we arrange the vertical and horizontal scales of the graph to reflect the ranges of values of consumption and income, and we mark the scales in convenient increments. As you can see, the values marked on the scales cover all the values in the table. The increments on both scales are \$100.

Because the graph has two dimensions, each point within it represents an income value and its associated consumption value. To find a point that represents one of the five income-consumption combinations in the table in Figure 1, we draw perpendiculars from the appropriate values on the vertical and horizontal axes. For example, to plot point *c* (the \$200 income-\$150 consumption point), we draw perpendiculars up from the horizontal (income) axis at \$200 and across from the vertical (consumption) axis at \$150. These perpendiculars intersect at point *c*, which represents this particular income-consumption combination. You should verify that the other income-consumption combinations shown in the table are properly located in the graph in Figure 1. Finally, by assuming that the same general relationship between income and

**FIGURE 1** Graphing the direct relationship between consumption and income. Two sets of data that are positively or directly related, such as consumption and income, graph as an upsloping line.

| Income per Week | Consumption per Week | Point    |
|-----------------|----------------------|----------|
| \$ 0            | \$ 50                | <i>a</i> |
| 100             | 100                  | <i>b</i> |
| 200             | 150                  | <i>c</i> |
| 300             | 200                  | <i>d</i> |
| 400             | 250                  | <i>e</i> |



consumption prevails for all other incomes, we draw a line or smooth curve to connect these points. That line or curve represents the income-consumption relationship.

If the graph is a straight line, as in Figure 1, we say the relationship is *linear*.

## Direct and Inverse Relationships

The line in Figure 1 slopes upward to the right, so it depicts a **direct relationship** between income and consumption. By a **direct relationship** (or positive relationship) we mean that two variables—in this case, consumption and income—change in the *same* direction. An increase in consumption is associated with an increase in income; a decrease in consumption accompanies a decrease in income. When two sets of data are positively or directly related, they always graph as an *upsloping* line, as in Figure 1.

In contrast, two sets of data may be inversely related. Consider the table in Figure 2, which shows the relationship between the price of basketball tickets and game attendance at Gigantic State University (GSU). Here we have an **inverse relationship** (or negative relationship) because the two variables change in *opposite* directions. When ticket prices decrease, attendance increases. When ticket prices increase, attendance decreases. The six data points in the table in Figure 2 are plotted in the graph. Observe that an inverse relationship always graphs as a *downsloping* line.

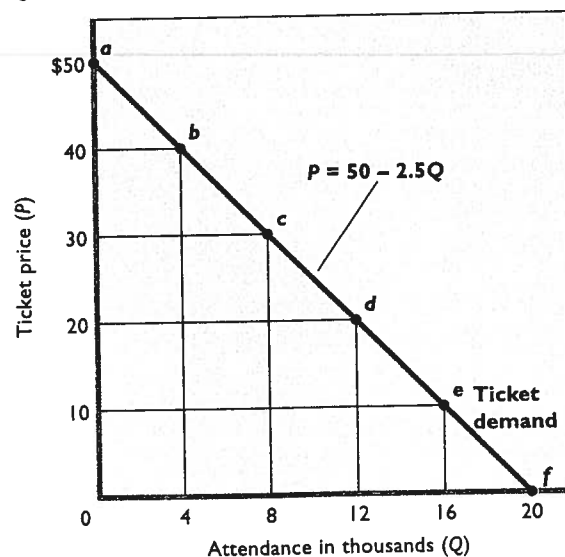
## Dependent and Independent Variables

Although it is not always easy, economists seek to determine which variable is the “cause” and which is the “effect.” Or, more formally, they seek the independent variable and the dependent variable. The **independent variable** is the cause or source; it is the variable that changes first. The **dependent variable** is the effect or outcome; it is the variable that changes because of the change in the independent variable. As noted in our income-consumption example, income generally is the independent variable and consumption the dependent variable. Income causes consumption to be what it is rather than the other way around. Similarly, ticket prices (set in advance of the season) determine attendance at GSU basketball games; attendance at games does not determine the ticket prices for those games. Ticket price is the independent variable, and the quantity of tickets purchased is the dependent variable.

You may recall from your high school courses that mathematicians always put the independent variable (cause) on the horizontal axis and the dependent variable (effect) on the vertical axis. Economists are less tidy; their graphing of independent and dependent variables is more arbitrary. Their conventional graphing of the income-consumption relationship is consistent with mathematical presentation, but economists put price and cost data on

**FIGURE 2** Graphing the inverse relationship between ticket prices and game attendance. Two sets of data that are negatively or inversely related, such as ticket price and the attendance at basketball games, graph as a downsloping line.

| Ticket Price | Attendance, Thousands | Point |
|--------------|-----------------------|-------|
| \$50         | 0                     | a     |
| 40           | 4                     | b     |
| 30           | 8                     | c     |
| 20           | 12                    | d     |
| 10           | 16                    | e     |
| 0            | 20                    | f     |



the vertical axis. Hence, economists' graphing of GSU's ticket price–attendance data conflicts with normal mathematical procedure.

## Other Things Equal

Our simple two-variable graphs purposely ignore many other factors that might affect the amount of consumption occurring at each income level or the number of people who attend GSU basketball games at each possible ticket price. When economists plot the relationship between any two variables, they employ the *ceteris paribus* (other-things-equal) assumption. Thus, in Figure 1 all factors other than income that might affect the amount of consumption are presumed to be constant or unchanged. Similarly, in Figure 2 all factors other than ticket price that might influence attendance at GSU basketball games are assumed constant. In reality, “other things” are not equal; they often change, and when they do, the relationship represented in our two tables and graphs will change. Specifically, the lines we have plotted would shift to new locations.

Consider a stock market “crash.” The dramatic drop in the value of stocks might cause people to feel less wealthy and therefore less willing to consume at each level of income. The result might be a downward shift of the consumption line. To see this, you should plot a new consumption line in Figure 1, assuming that consumption is, say, \$20 less at each income level. Note that the relationship remains direct; the line merely shifts downward to reflect less consumption spending at each income level.

Similarly, factors other than ticket prices might affect GSU game attendance. If GSU loses most of its games, attendance at GSU games might be less at each ticket price. To see this, redraw Figure 2, assuming that 2000 fewer fans attend GSU games at each ticket price. (Key Appendix Question 2)

## Slope of a Line

Lines can be described in terms of their slopes. The **slope of a straight line** is the ratio of the vertical change (the rise or drop) to the horizontal change (the run) between any two points of the line.

**Positive Slope** Between point *b* and point *c* in Figure 1 the rise or vertical change (the change in consumption) is +\$50 and the run or horizontal change (the change in income) is +\$100. Therefore:

$$\text{Slope} = \frac{\text{vertical change}}{\text{horizontal change}} = \frac{+50}{+100} = \frac{1}{2} = .5$$

Note that our slope of  $\frac{1}{2}$  or .5 is positive because consumption and income change in the same direction; that is, consumption and income are directly or positively related.

The slope of .5 tells us there will be a \$1 increase in consumption for every \$2 increase in income. Similarly, it indicates that for every \$2 decrease in income there will be a \$1 decrease in consumption.

**Negative Slope** Between any two of the identified points in Figure 2, say, point *c* and point *d*, the vertical change is  $-10$  (the drop) and the horizontal change is  $+4$  (the run). Therefore:

$$\begin{aligned}\text{Slope} &= \frac{\text{vertical change}}{\text{horizontal change}} = \frac{-10}{+4} \\ &= -2\frac{1}{2} = -2.5\end{aligned}$$

This slope is negative because ticket price and attendance have an inverse relationship.

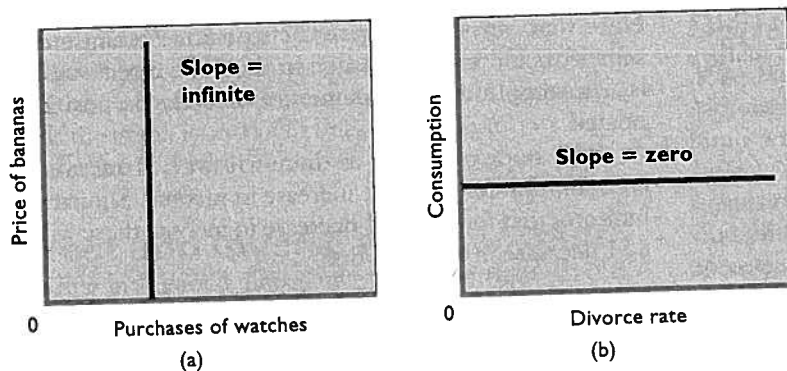
Note that on the horizontal axis attendance is stated in thousands of people. So the slope of  $-10/+4$  or  $-2.5$  means that lowering the price by \$10 will increase attendance by 4000 people. This is the same as saying that a \$2.50 price reduction will increase attendance by 1000 persons.

**Slopes and Measurement Units** The slope of a line will be affected by the choice of units for either variable. If, in our ticket price illustration, we had chosen to measure attendance in individual people, our horizontal change would have been 4000 and the slope would have been

$$\text{Slope} = \frac{-10}{+4000} = \frac{-1}{+400} = -.0025$$

The slope depends on the way the relevant variables are measured.

**Slopes and Marginal Analysis** Recall that economics is largely concerned with changes from the status quo. The concept of slope is important in economics because it reflects marginal changes—those involving 1 more (or 1 less) unit. For example, in Figure 1 the .5 slope shows that \$.50 of extra or marginal consumption is associated with each \$1 change in income. In this example, people collectively will consume \$.50 of any \$1 increase in their incomes and reduce their consumption by \$.50 for each \$1 decline in income.



**FIGURE 3** Infinite and zero slopes. (a) A line parallel to the vertical axis has an infinite slope. Here, purchases of watches remain the same no matter what happens to the price of bananas. (b) A line parallel to the horizontal axis has a slope of zero. Here, consumption remains the same no matter what happens to the divorce rate. In both (a) and (b), the two variables are totally unrelated to one another.

**Infinite and Zero Slopes** Many variables are unrelated or independent of one another. For example, the quantity of wristwatches purchased is not related to the price of bananas. In Figure 3a we represent the price of bananas on the vertical axis and the quantity of watches demanded on the horizontal axis. The graph of their relationship is the line parallel to the vertical axis, indicating that the same quantity of watches is purchased no matter what the price of bananas. The slope of such a line is *infinite*.

Similarly, aggregate consumption is completely unrelated to the nation's divorce rate. In Figure 3b we put consumption on the vertical axis and the divorce rate on the horizontal axis. The line parallel to the horizontal axis represents this lack of relatedness. This line has a slope of *zero*.

### Vertical Intercept

A line can be located on a graph (without plotting points) if we know its slope and its vertical intercept. The **vertical intercept** of a line is the point where the line meets the vertical axis. In Figure 1 the intercept is \$50. This intercept means that if current income were zero, consumers would still spend \$50. They might do this through borrowing or by selling some of their assets. Similarly, the \$50 vertical intercept in Figure 2 shows that at a \$50 ticket price, GSU's basketball team would be playing in an empty arena.

### Equation of a Linear Relationship

If we know the vertical intercept and slope, we can describe a line succinctly in equation form. In its general form, the equation of a straight line is

$$y = a + bx$$

where  $y$  = dependent variable

$a$  = vertical intercept

$b$  = slope of line

$x$  = independent variable

For our income-consumption example, if  $C$  represents consumption (the dependent variable) and  $Y$  represents

income (the independent variable), we can write  $C = a + bY$ . By substituting the known values of the intercept and the slope, we get

$$C = 50 + .5Y$$

This equation also allows us to determine the amount of consumption  $C$  at any specific level of income. You should use it to confirm that at the \$250 income level, consumption is \$175.

When economists reverse mathematical convention by putting the independent variable on the vertical axis and the dependent variable on the horizontal axis, then  $y$  stands for the independent variable, rather than the dependent variable in the general form. We noted previously that this case is relevant for our GSU ticket price-attendance data. If  $P$  represents the ticket price (independent variable) and  $Q$  represents attendance (dependent variable), their relationship is given by

$$P = 50 - 2.5Q$$

where the vertical intercept is 50 and the negative slope is  $-2\frac{1}{2}$ , or  $-2.5$ . Knowing the value of  $P$  lets us solve for  $Q$ , our dependent variable. You should use this equation to predict GSU ticket sales when the ticket price is \$15. (**Key Appendix Question 3**)

### Slope of a Nonlinear Curve

We now move from the simple world of linear relationships (straight lines) to the more complex world of nonlinear relationships. The slope of a straight line is the same at all its points. The slope of a line representing a nonlinear relationship changes from one point to another. Such lines are referred to as *curves*. (It is also permissible to refer to a straight line as a "curve.")

Consider the downsloping curve in Figure 4. Its slope is negative throughout, but the curve flattens as we move down along it. Thus, its slope constantly changes; the curve has a different slope at each point.

To measure the slope at a specific point, we draw a straight line tangent to the curve at that point. A line is *tangent* at a point if it touches, but does not intersect, the curve at that point. Thus line *aa* is tangent to the curve in Figure 4 at point *A*. The slope of the curve at that point is equal to the slope of the tangent line. Specifically, the total vertical change (drop) in the tangent line *aa* is  $-20$  and the total horizontal change (run) is  $+5$ . Because the slope of the tangent line *aa* is  $-20/+5$ , or  $-4$ , the slope of the curve at point *A* is also  $-4$ .



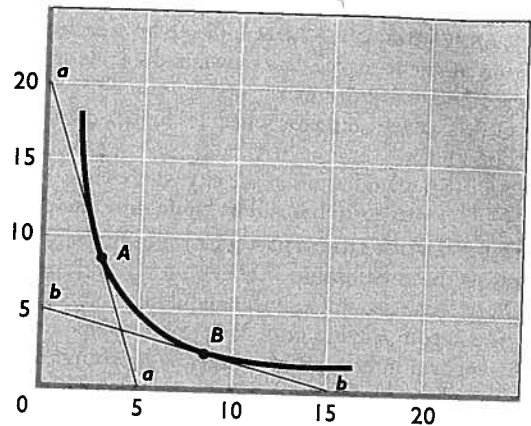
### G 1.3

Curves and slopes

Line *bb* in Figure 4 is tangent to the curve at point *B*. Following the same procedure, we find the slope at *B* to be  $-5/+15$ , or  $-\frac{1}{3}$ . Thus, in this flatter part of the curve, the slope is less negative. (**Key Appendix Question 7**)

**FIGURE 4** Determining the slopes of curves.

The slope of a nonlinear curve changes from point to point on the curve. The slope at any point (say, *B*) can be determined by drawing a straight line that is tangent to that point (line *bb*) and calculating the slope of that line.



## Appendix Summary

1. Graphs are a convenient and revealing way to represent economic relationships.
2. Two variables are positively or directly related when their values change in the same direction. The line (curve) representing two directly related variables slopes upward.
3. Two variables are negatively or inversely related when their values change in opposite directions. The curve representing two inversely related variables slopes downward.
4. The value of the dependent variable (the "effect") is determined by the value of the independent variable (the "cause").
5. When the "other factors" that might affect a two-variable relationship are allowed to change, the graph of the relationship will likely shift to a new location.
6. The slope of a straight line is the ratio of the vertical change to the horizontal change between any two points. The slope of an upsloping line is positive; the slope of a downsloping line is negative.
7. The slope of a line or curve depends on the units used in measuring the variables. It is especially relevant for economics because it measures marginal changes.
8. The slope of a horizontal line is zero; the slope of a vertical line is infinite.
9. The vertical intercept and slope of a line determine its location; they are used in expressing the line—and the relationship between the two variables—as an equation.
10. The slope of a curve at any point is determined by calculating the slope of a straight line tangent to the curve at that point.

## Appendix Terms and Concepts

horizontal axis  
vertical axis  
direct relationship

inverse relationship  
independent variable  
dependent variable

slope of a straight line  
vertical intercept

## Appendix Study Questions

1. Briefly explain the use of graphs as a way to represent economic relationships. What is an inverse relationship? How does it graph? What is a direct relationship? How does it graph? Graph and explain the relationships you would expect

to find between (a) the number of inches of rainfall per month and the sale of umbrellas, (b) the amount of tuition and the level of enrollment at a university, and (c) the popularity of an entertainer and the price of her concert tickets.

## IN THIS CHAPTER YOU WILL LEARN:

- The difference between a command system and a market system.
- The main characteristics of the market system.
- How the market system decides what to produce, how to produce it, and who obtains it.
- How the market system adjusts to change and promotes progress.
- The mechanics of the circular flow model.

## The Market System and the Circular Flow

You are at the mall. Suppose you were assigned to compile a list of all the individual goods and services there, including the different brands and variations of each type of product. That task would be daunting and the list would be long! And even though a single shopping mall contains a remarkable quantity and variety of goods, it is only a tiny part of the national economy.

Who decided that the particular goods and services available at the mall and in the broader economy should be produced? How did the producers determine which technology and types of resources to use in producing these particular goods? Who will obtain these products? What accounts for the new and improved products among these goods? This chapter will answer these and related questions.

## Economic Systems

Every society needs to develop an **economic system**—a particular set of institutional arrangements and a coordinating mechanism—to respond to the economizing problem. The economic system has to determine what goods are produced, how they are produced, who gets them, how to accommodate change, and how to promote technological progress.

Economic systems differ as to (1) who owns the factors of production and (2) the method used to motivate, coordinate, and direct economic activity. Economic systems have two polar extremes: the command system and the market system.

### The Command System

The **command system** is also known as *socialism* or *communism*. In that system, government owns most property resources and economic decision making occurs through a central economic plan. A central planning board appointed by the government makes nearly all the major decisions concerning the use of resources, the composition and distribution of output, and the organization of production. The government owns most of the business firms, which produce according to government directives. The central planning board determines production goals for each enterprise and specifies the amount of resources to be allocated to each enterprise so that it can reach its production goals. The division of output between capital and consumer goods is centrally decided, and capital goods are allocated among industries on the basis of the central planning board's long-term priorities.

A pure command economy would rely exclusively on a central plan to allocate the government-owned property resources. But, in reality, even the preeminent command economy—the Soviet Union—tolerated some private ownership and incorporated some markets before its collapse in 1992. Recent reforms in Russia and most of the eastern European nations have to one degree or another transformed their command economies to capitalistic, market-oriented systems. China's reforms have not gone as far, but they have greatly reduced the reliance on central planning. Although government ownership of resources and capital in China is still extensive, the nation has increasingly relied on free markets to organize and coordinate its economy. North Korea and Cuba are the last prominent remaining examples of largely centrally planned economies. Other countries using mainly the command system include Turkmenistan, Laos, Belarus, Libya, Myanmar, and Iran. Later in this chapter, we will explore the main reasons for the general demise of the command systems.

## The Market System

The polar alternative to the command system is the **market system**, or *capitalism*. The system is characterized by the private ownership of resources and the use of markets and prices to coordinate and direct economic activity. Participants act in their own self-interest. Individuals and businesses seek to achieve their economic goals through their own decisions regarding work, consumption, or production. The system allows for the private ownership of capital, communicates through prices, and coordinates economic activity through *markets*—places where buyers and sellers come together. Goods and services are produced and resources are supplied by whoever is willing and able to do so. The result is competition among independently acting buyers and sellers of each product and resource. Thus, economic decision making is widely dispersed. Also, the high potential monetary rewards create powerful incentives for existing firms to innovate and entrepreneurs to pioneer new products and processes.

In *pure capitalism*—or *laissez-faire capitalism*—government's role would be limited to protecting private property and establishing an environment appropriate to the operation of the market system. The term “laissez-faire” means “let it be,” that is, keep government from interfering with the economy. The idea is that such interference will disturb the efficient working of the market system.



### O 2.1

Laissez-faire

But in the capitalism practiced in the United States and most other countries, government plays a substantial role in the economy. It not only provides the rules for economic activity but also promotes economic stability and growth, provides certain goods and services that would otherwise be underproduced or not produced at all, and modifies the distribution of income. The government, however, is not the dominant economic force in deciding what to produce, how to produce it, and who will get it. That force is the market.

## Characteristics of the Market System

An examination of some of the key features of the market system in detail will be very instructive.

### Private Property

In a market system, private individuals and firms, not the government, own most of the property resources (land and capital). It is this extensive private ownership of

capital that gives capitalism its name. This right of **private property**, coupled with the freedom to negotiate binding legal contracts, enables individuals and businesses to obtain, use, and dispose of property resources as they see fit. The right of property owners to designate who will receive their property when they die helps sustain the institution of private property.

Property rights encourage investment, innovation, exchange, maintenance of property, and economic growth. Nobody would stock a store, build a factory, or clear land for farming if someone else, or the government itself, could take that property for his or her own benefit.

Property rights also extend to intellectual property through patents, copyrights, and trademarks. Such long-term protection encourages people to write books, music, and computer programs and to invent new products and production processes without fear that others will steal them and the rewards they may bring.

Moreover, property rights facilitate exchange. The title to an automobile or the deed to a cattle ranch assures the buyer that the seller is the legitimate owner. Also, property rights encourage owners to maintain or improve their property so as to preserve or increase its value. Finally, property rights enable people to use their time and resources to produce more goods and services, rather than using them to protect and retain the property they have already produced or acquired.

## Freedom of Enterprise and Choice

Closely related to private ownership of property is freedom of enterprise and choice. The market system requires that various economic units make certain choices, which are expressed and implemented in the economy's markets:

- **Freedom of enterprise** ensures that entrepreneurs and private businesses are free to obtain and use economic resources to produce their choice of goods and services and to sell them in their chosen markets.
- **Freedom of choice** enables owners to employ or dispose of their property and money as they see fit. It also allows workers to try to enter any line of work for which they are qualified. Finally, it ensures that consumers are free to buy the goods and services that best satisfy their wants and that their budgets allow.

These choices are free only within broad legal limitations, of course. Illegal choices such as selling human organs or buying illicit drugs are punished through fines and imprisonment. (Global Perspective 2.1 reveals that the degree of economic freedom varies greatly from economy to economy.)

## Self-Interest

In the market system, **self-interest** is the motivating force of the various economic units as they express their free choices. Self-interest simply means that each economic unit tries to achieve its own particular goal, which usually requires delivering something of value to others. Entrepreneurs try to maximize profit or minimize loss. Property owners try to get the highest price for the sale or rent of their resources. Workers try to maximize their utility (satisfaction) by finding jobs that offer the best combination of wages, hours, fringe benefits, and working conditions. Consumers try to obtain the products they want at the lowest possible price and apportion their



### O 2.2

Self-interest



## GLOBAL PERSPECTIVE 2.1

### Index of Economic Freedom, Selected Economies

The Index of Economic Freedom measures economic freedom using 10 broad categories such as trade policy, property rights, and government intervention, with each category containing more than 50 specific criteria. The index then ranks 157 economies according to their degree of economic freedom. A few selected rankings for 2006 are listed below.

| FREE          |               |
|---------------|---------------|
| 1             | Hong Kong     |
| 3             | Ireland       |
| 9             | United States |
| MOSTLY FREE   |               |
| 22            | Belgium       |
| 33            | Spain         |
| 44            | France        |
| MOSTLY UNFREE |               |
| 81            | Brazil        |
| 111           | China         |
| 122           | Russia        |
| REPPRESSED    |               |
| 150           | Cuba          |
| 152           | Venezuela     |
| 157           | North Korea   |

Source: Heritage Foundation ([www.heritage.org](http://www.heritage.org)) and *The Wall Street Journal*.

expenditures to maximize their utility. The motive of self-interest gives direction and consistency to what might otherwise be a chaotic economy.

## Competition

The market system depends on **competition** among economic units. The basis of this competition is freedom of choice exercised in pursuit of a monetary return. Very broadly defined, competition requires:

- Two or more buyers and two or more sellers acting independently in a particular product or resource market. (Usually there are many more than two buyers or sellers.)
- Freedom of sellers and buyers to enter or leave markets, on the basis of their economic self-interest.

Competition among buyers and sellers diffuses economic power within the businesses and households that make up the economy. When there are many buyers and sellers acting independently in a market, no single buyer or seller can dictate the price of the product or resource because others can undercut that price.

Competition also implies that producers can enter or leave an industry; no insurmountable barriers prevent an industry's expanding or contracting. This freedom of an industry to expand or contract provides the economy with the flexibility needed to remain efficient over time. Freedom of entry and exit enables the economy to adjust to changes in consumer tastes, technology, and resource availability.

The diffusion of economic power inherent in competition limits the potential abuse of that power. A producer that charges more than the competitive market price will lose sales to other producers. An employer who pays less than the competitive market wage rate will lose workers to other employers. A firm that fails to exploit new technology will lose profits to firms that do. Competition is the basic regulatory force in the market system.

## Markets and Prices

We may wonder why an economy based on self-interest does not collapse in chaos. If consumers want breakfast cereal but businesses choose to produce running shoes and resource suppliers decide to make computer software, production would seem to be deadlocked by the apparent inconsistencies of free choices.

In reality, the millions of decisions made by households and businesses are highly coordinated with one another by markets and prices, which are key components of the market system. They give the system its ability to coordinate millions of daily economic decisions. A **market** is

an institution or mechanism that brings buyers ("demanders") and sellers ("suppliers") into contact. A market system conveys the decisions made by buyers and sellers of products and resources. The decisions made on each side of the market determine a set of product and resource prices that guide resource owners, entrepreneurs, and consumers as they make and revise their choices and pursue their self-interest.

Just as competition is the regulatory mechanism of the market system, the market system itself is the organizing and coordinating mechanism. It is an elaborate communication network through which innumerable individual free choices are recorded, summarized, and balanced. Those who respond to market signals and heed market dictates are rewarded with greater profit and income; those who do not respond to those signals and choose to ignore market dictates are penalized. Through this mechanism society decides what the economy should produce, how production can be organized efficiently, and how the fruits of production are to be distributed among the various units that make up the economy.

### QUICK REVIEW 2.1

- The market system rests on the private ownership of property and on freedom of enterprise and freedom of choice.
- The market system permits consumers, resource suppliers, and businesses to pursue and further their self-interest.
- Competition diffuses economic power and limits the actions of any single seller or buyer.
- The coordinating mechanism of capitalism is a system of markets and prices.

## Technology and Capital Goods

In the market system, competition, freedom of choice, self-interest, and personal reward provide the opportunity and motivation for technological advance. The monetary rewards for new products or production techniques accrue directly to the innovator. The market system therefore encourages extensive use and rapid development of complex capital goods: tools, machinery, large-scale factories, and facilities for storage, communication, transportation, and marketing.

Advanced technology and capital goods are important because the most direct methods of production are often the least efficient. The only way to avoid that inefficiency is to rely on capital goods. It would be ridiculous for a farmer

to go at production with bare hands. There are huge benefits to be derived from creating and using such capital equipment as plows, tractors, and storage bins. The more efficient production means much more abundant outputs.

## Specialization

The extent to which market economies rely on **specialization** is extraordinary. Specialization is the use of resources of an individual, firm, region, or nation to produce one or a few goods or services rather than the entire range of goods and services. Those goods and services are then exchanged for a full range of desired products. The majority of consumers produce virtually none of the goods and services they consume, and they consume little or nothing of the items they produce. The person working nine to five installing windows in Lincoln may own a Ford. Many farmers sell their milk to the local dairy and then buy butter at the local grocery store. Society learned long ago that self-sufficiency breeds inefficiency. The jack-of-all-trades may be a very colorful individual but is certainly not an efficient producer.

**Division of Labor** Human specialization—called the **division of labor**—contributes to a society's output in several ways:

- **Specialization makes use of differences in ability.**



### O 2.3

Specialization  
division of labor

Specialization enables individuals to take advantage of existing differences in their abilities and skills. If Peyton is strong, athletic, and good at throwing a football and Beyonce is beautiful, agile, and can sing, their distribution of talents can be most efficiently used if Peyton plays professional football and Beyonce records songs and gives concerts.

- **Specialization fosters learning by doing.** Even if the abilities of two people are identical, specialization may still be advantageous. By devoting time to a single task, a person is more likely to develop the skills required and to improve techniques than by working at a number of different tasks. You learn to be a good lawyer by studying and practicing law.
- **Specialization saves time.** By devoting time to a single task, a person avoids the loss of time incurred in shifting from one job to another. Also, time is saved by not “fumbling around” with a task that one is not trained to do.

For all these reasons, specialization increases the total output society derives from limited resources.

**Geographic Specialization** Specialization also works on a regional and international basis. It is conceivable that oranges could be grown in Nebraska, but because of the unsuitability of the land, rainfall, and temperature, the costs would be very high. And it is conceivable that wheat could be grown in Florida, but such production would be costly for similar geographical reasons. So Nebraskans produce products—wheat in particular—for which their resources are best suited, and Floridians do the same, producing oranges and other citrus fruits. By specializing, both economies produce more than is needed locally. Then, very sensibly, Nebraskans and Floridians swap some of their surpluses—wheat for oranges, oranges for wheat.

Similarly, on an international scale, the United States specializes in producing such items as commercial aircraft and computers, which it sells abroad in exchange for video recorders from Japan, bananas from Honduras, and woven baskets from Thailand. Both human specialization and geographic specialization are needed to achieve efficiency in the use of limited resources.

## Use of Money

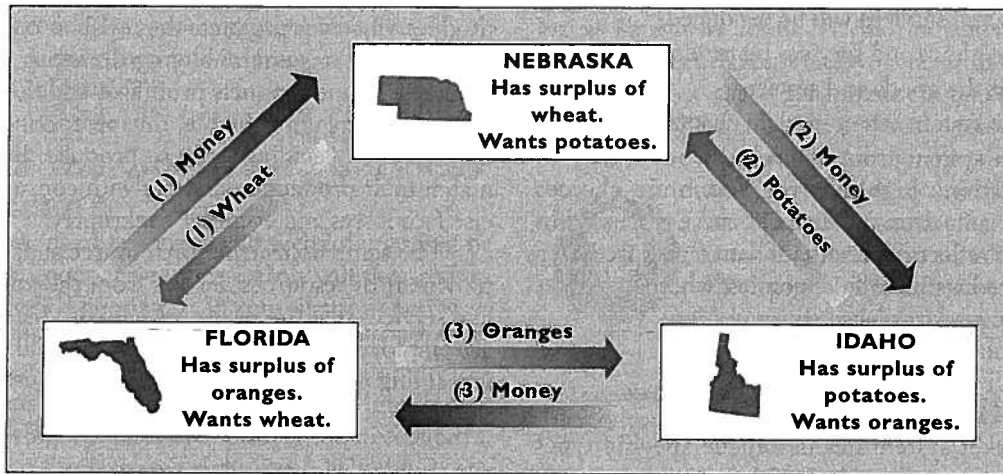
A rather obvious characteristic of any economic system is the extensive use of money. Money performs several functions, but first and foremost it is a **medium of exchange**. It makes trade easier.

Specialization requires exchange. Exchange can, and sometimes does, occur through **barter**—swapping goods for goods, say, wheat for oranges. But barter poses serious problems because it requires a *coincidence of wants* between the buyer and the seller. In our example, we assumed that Nebraskans had excess wheat to trade and wanted oranges. And we assumed that Floridians had excess oranges to trade and wanted wheat. So an exchange occurred. But if such a coincidence of wants is missing, trade is stymied.

Suppose that Nebraska has no interest in Florida's oranges but wants potatoes from Idaho. And suppose that Idaho wants Florida's oranges but not Nebraska's wheat. And, to complicate matters, suppose that Florida wants some of Nebraska's wheat but none of Idaho's potatoes. We summarize the situation in Figure 2.1

In none of the cases shown in the figure is there a coincidence of wants. Trade by barter clearly would be difficult. Instead, people in each state use **money**, which is simply a convenient social invention to facilitate exchanges of goods and services. Historically, people have used cattle, cigarettes, shells, stones, pieces of metal, and many other commodities, with varying degrees of success, as a medium of exchange. But to serve as money, an item needs to pass only one test: It must be generally acceptable to sellers in exchange for their

**FIGURE 2.1 Money facilitates trade when wants do not coincide.** The use of money as a medium of exchange permits trade to be accomplished despite a noncoincidence of wants. (1) Nebraska trades the wheat that Florida wants for money from Floridians; (2) Nebraska trades the money it receives from Florida for the potatoes it wants from Idaho; (3) Idaho trades the money it receives from Nebraska for the oranges it wants from Florida.



goods and services. Money is socially defined; whatever society accepts as a medium of exchange *is* money.

Most economies use pieces of paper as money. The use of paper dollars (currency) as a medium of exchange is what enables Nebraska, Florida, and Idaho to overcome their trade stalemate, as demonstrated in Figure 2.1.

On a global basis different nations have different currencies, and that complicates specialization and exchange. But markets in which currencies are bought and sold make it possible for U.S. residents, Japanese, Germans, Britons, and Mexicans, through the swapping of dollars, yen, euros, pounds, and pesos, one for another, to exchange goods and services.

### CONSIDER THIS ...



#### Buy American?

Will “buying American” make Americans better off? No, says Dallas Federal Reserve economist W. Michael Cox:

A common myth is that it is better for Americans to spend their money at home than abroad. The best way to expose the fallacy of this argument is to take it to its logical extreme. If it is better for me to spend

my money here than abroad, then it is even better yet to buy in Texas than in New York, better yet to buy in Dallas than in Houston ... in my own neighborhood ... within my own family ... to consume only what I can produce. Alone and poor.\*

\*“The Fruits of Free Trade,” Federal Reserve Bank of Dallas, Annual Report 2002, p. 16.

## Active, but Limited, Government

An active, but limited, government is the final characteristic of market systems in modern advanced industrial economies. Although a market system promotes a high degree of efficiency in the use of its resources, it has certain inherent shortcomings, called “market failures.” We will discover in subsequent chapters that government can increase the overall effectiveness of the economic system in several ways.

### QUICK REVIEW 2.2

- The market systems of modern industrial economies are characterized by extensive use of technologically advanced capital goods. Such goods help these economies achieve greater efficiency in production.
- Specialization is extensive in market systems; it enhances efficiency and output by enabling individuals, regions, and nations to produce the goods and services for which their resources are best suited.
- The use of money in market systems facilitates the exchange of goods and services that specialization requires.

## Five Fundamental Questions

The key features of the market system help explain how market economies respond to 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?

These five questions highlight the economic choices underlying the production possibilities curve discussed in Chapter 1. They reflect the reality of scarce resources in a world of unlimited wants. All economies, whether market or command, must address these five questions.

## What Will Be Produced?

How will a market system decide on the specific types and quantities of goods to be produced? The simple answer is this: The goods and services produced at a continuing profit will be produced, and those produced at a continuing loss will not. Profits and losses are the difference between the total revenue (TR) a firm receives from the sale of its products and the total opportunity cost (TC) of producing those products. (For economists, economic costs include not only wage and salary payments to labor, and interest and rental payments for capital and land, but also payments to the entrepreneur for organizing and combining the other resources to produce a commodity.)

Continuing economic profit ( $TR > TC$ ) in an industry results in expanded production and the movement of resources toward that industry. Existing firms grow and new firms enter. The industry expands. Continuing losses ( $TC > TR$ ) in an industry leads to reduced production and the exit of resources from that industry. Some existing firms shrink in size; others go out of business. The industry contracts. In the market system, consumers are sovereign (in command). **Consumer sovereignty** is crucial in determining the types and quantities of goods produced. Consumers spend their income on the goods they are most willing and able to buy. Through these “dollar votes” they register their wants in the market. If the dollar votes for a certain product are great enough to create a profit, businesses will produce that product and offer it for sale. In contrast, if the dollar votes do not create sufficient revenues to cover costs, businesses will not produce the product. So the consumers are sovereign. They collectively direct resources to industries that are meeting consumer wants and away from industries that are not meeting consumer wants.

The dollar votes of consumers determine not only which industries will continue to exist but also which products will survive or fail. Only profitable industries, firms, and products survive. So firms are not as free to produce whatever products they wish as one might otherwise think. Consumers’ buying decisions make the production of some products profitable and the production of other products unprofitable, thus restricting the choice of businesses in deciding what to produce. Businesses must match their production choices with consumer choices or else face losses and eventual bankruptcy.

The same holds true for resource suppliers. The employment of resources derives from the sale of the goods and services that the resources help produce. Autoworkers are employed because automobiles are sold. There are few remaining professors of early Latin because there are few

### CONSIDER THIS ...



#### McHits and McMisses

McDonald's has introduced several new menu items over the decades. Some have been profitable “hits,” while others have been “misses.” Ultimately, consumers decide whether a menu item is profitable and therefore whether it stays on the McDonald's menu.

- Hulaburger (1962)—McMiss
- Filet-O-Fish (1963)—McHit
- Strawberry shortcake (1966)—McMiss
- Big Mac (1968)—McHit
- Hot apple pie (1968)—McHit
- Egg McMuffin (1975)—McHit
- Drive-thru (1975)—McHit
- Chicken McNuggets (1983)—McHit
- Extra Value Meal (1991)—McHit
- McLean Deluxe (1991)—McMiss
- Arch Deluxe (1996)—McMiss
- 55-cent special (1997)—McMiss
- Big Xtra (1999)—McHit

Source: “Polishing the Golden Arches,” *Forbes*, June 15, 1998, pp. 42–43, updated.

people desiring to learn the Latin language. Resource suppliers, desiring to earn income, are not truly free to allocate their resources to the production of goods that consumers do not value highly. Consumers register their preferences in the market; producers and resource suppliers, prompted by their own self-interest, respond appropriately. (Key Question 8)

## How Will the Goods and Services Be Produced?

What combinations of resources and technologies will be used to produce goods and services? How will the production be organized? The answer: In combinations and ways that minimize the cost per unit of output. Because competition eliminates high-cost producers, profitability requires that firms produce their output at minimum cost per unit. Achieving this least-cost production necessitates, for example, that firms use the right mix of labor and capital, given the prices and productivity of those resources. It also means locating production facilities optimally to hold down production and transportation expenses.

Least-cost production also means that firms must employ the most economically efficient technique of production in producing their output. The most efficient production technique depends on:

- The available technology, that is, the various combinations of resources that will produce the desired results.
- The prices of the needed resources.

A technique that requires just a few inputs of resources to produce a specific output may be highly inefficient economically if those resources are valued very highly in the market. Economic efficiency means obtaining a particular output of product with the least input of scarce resources, when both output and resource inputs are measured in dollars and cents. The combination of resources that will produce, say, \$15 worth of bathroom soap at the lowest possible cost is the most efficient.

Suppose there are three possible techniques for producing the desired \$15 worth of bars of soap. Suppose also that the quantity of each resource required by each production technique and the prices of the required resources are as shown in Table 2.1. By multiplying the required quantities of each resource by its price in each of the three techniques, we can determine the total cost of producing \$15 worth of soap by means of each technique.



**W 2.1**  
Least-cost  
production

Technique 2 is economically the most efficient, because it is the least costly. It enables society to obtain \$15 worth of output by using a smaller amount of resources—\$13 worth—than the \$15 worth required by the two other techniques. Competition will dictate that producers use technique 2. Thus, the question of how goods will be produced is answered. They will be produced in a least-cost way.

A change in either technology or resource prices, however, may cause a firm to shift from the technology it is using. If the price of labor falls to \$.50, technique 1 becomes more desirable than technique 2. Firms will find they can lower their costs by shifting to a technology that uses more of the resource whose price has fallen. Exercise: Would a new technique involving 1 unit of labor, 4 of land, 1 of capital, and 1 of entrepreneurial ability be preferable to the techniques listed in Table 2.1, assuming the resource prices shown there? (Key Question 9)

## Who Will Get the Output?

The market system enters the picture in two ways when determining the distribution of total output. Generally, any product will be distributed to consumers on the basis of their ability and willingness to pay its existing market price. If the price of some product, say, a small sailboat, is \$3000, then buyers who are willing and able to pay that price will “sail, sail away.” Consumers who are unwilling or unable to pay the price will be “sitting on the dock of the bay.”

**TABLE 2.1** Three Techniques for Producing \$15 Worth of Bar Soap

| Resource                             | Price per Unit of Resource | Units of Resource |      |             |      |             |      |
|--------------------------------------|----------------------------|-------------------|------|-------------|------|-------------|------|
|                                      |                            | Technique 1       |      | Technique 2 |      | Technique 3 |      |
|                                      |                            | Units             | Cost | Units       | Cost | Units       | Cost |
| Labor                                | \$2                        | 4                 | \$ 8 | 2           | \$ 4 | 1           | \$ 2 |
| Land                                 | 1                          | 1                 | 1    | 3           | 3    | 4           | 4    |
| Capital                              | 3                          | 1                 | 3    | 1           | 3    | 2           | 6    |
| Entrepreneurial ability              | 3                          | 1                 | 3    | 1           | 3    | 1           | 3    |
| Total cost of \$15 worth of bar soap |                            |                   | \$15 |             | \$13 |             | \$15 |

The ability to pay the prices for sailboats and other products depends on the amount of income that consumers have, along with the prices of, and preferences for, various goods. If consumers have sufficient income and want to spend their money on a particular good, they can have it. And the amount of income they have depends on (1) the quantities of the property and human resources they supply and (2) the prices those resources command in the resource market. Resource prices (wages, interest, rent, profit) are crucial in determining the size of each person's income and therefore each person's ability to buy part of the economy's output. If a lawyer earning \$200 an hour and a recreational worker earning \$10 an hour both work the same number of hours each year, the lawyer will be able to take possession of 20 times as much of society's output as the recreational worker that year.

## How Will the System Accommodate Change?

Market systems are dynamic: Consumer preferences, technology, and supplies of resources all change. This means that the particular allocation of resources that is now the most efficient for a specific pattern of consumer tastes, range of technological alternatives, and amount of available resources will become obsolete and inefficient as consumer preferences change, new techniques of production are discovered, and resource supplies change over time. Can the market economy adjust to such changes?

Suppose consumer tastes change. For instance, assume that consumers decide they want more fruit juice and less milk than the economy currently provides. Those changes in consumer tastes will be communicated to producers through an increase in spending on fruit and a decline in spending on milk. Other things equal, prices and profits in the fruit juice industry will rise and those in the milk industry will fall. Self-interest will induce existing competitors to expand output and entice new competitors to enter the prosperous fruit industry and will in time force firms to scale down—or even exit—the depressed milk industry.

The higher prices and greater economic profit in the fruit-juice industry will not only induce that industry to expand but will also give it the revenue needed to obtain the resources essential to its growth. Higher prices and profits will permit fruit producers to attract more resources from less urgent alternative uses. The reverse occurs in the milk industry, where fewer workers and other resources are employed. These adjustments in the economy are appropriate responses to the changes in consumer tastes. This is consumer sovereignty at work.

The market system is a gigantic communications system. Through changes in prices and profits it communicates changes in such basic matters as consumer tastes and elicits appropriate responses from businesses and resource suppliers. By affecting price and profits, changes in consumer tastes direct the expansion of some industries and the contraction of others. Those adjustments are conveyed to the resource market. As expanding industries employ more resources and contracting industries employ fewer, the resulting changes in resource prices (wages and salaries, for example) and income flows guide resources from the contracting industries to the expanding industries.

This directing or guiding function of prices and profits is a core element of the market system. Without such a system, some administrative agency such as a government planning board would have to direct businesses and resources into the appropriate industries. A similar analysis shows that the system can and does adjust to other fundamental changes—for example, to changes in technology and in the prices of various resources.

## How Will the System Promote Progress?

Society desires economic growth (greater output) and higher standards of living (greater income per person). How does the market system promote technological improvements and capital accumulation, both of which contribute to a higher standard of living for society?

**Technological Advance** The market system provides a strong incentive for technological advance and enables better products and processes to supplant inferior ones. An entrepreneur or firm that introduces a popular new product will gain revenue and economic profit at the expense of rivals. Firms that are highly profitable one year may find they are in financial trouble just a few years later.

Technological advance also includes new and improved methods that reduce production or distribution costs. By passing part of its cost reduction on to the consumer through a lower product price, the firm can increase sales and obtain economic profit at the expense of rival firms.

Moreover, the market system promotes the *rapid spread* of technological advance throughout an industry. Rival firms must follow the lead of the most innovative firm or else suffer immediate losses and eventual failure. In some cases, the result is **creative destruction**: The creation of new products and production methods completely destroys

the market positions of firms that are wedded to existing products and older ways of doing business. Example: The advent of compact discs largely demolished long-play vinyl records, and MP3 and other digital technologies are now supplanting CDs.

**Capital Accumulation** Most technological advances require additional capital goods. The market system provides the resources necessary to produce those goods through increased dollar votes for capital goods. That is, the market system acknowledges dollar voting for capital goods as well as for consumer goods.

But who will register votes for capital goods? Answer: Entrepreneurs and owners of businesses. As receivers of profit income, they often use part of that income to purchase capital goods. Doing so yields even greater profit income in the future if the technological innovation is successful. Also, by paying interest or selling ownership shares, the entrepreneur and firm can attract some of the income of households as saving to increase their dollar votes for the production of more capital goods. (**Key Question 10**)

### QUICK REVIEW 2.3

- The output mix of the market system is determined by profits, which in turn depend heavily on consumer preferences. Economic profits cause industries to expand; losses cause industries to contract.
- Competition forces industries to use the least costly production methods.
- Competitive markets reallocate resources in response to changes in consumer tastes, technological advances, and changes in availability of resources.
- In a market economy, consumer income and product prices determine how output will be distributed.
- Competitive markets create incentives for technological advance and capital accumulation, both of which contribute to increases in standards of living.

## The “Invisible Hand”

In his 1776 book *The Wealth of Nations*, Adam Smith first noted that the operation of a market system creates a curious unity between private interests and social interests. Firms and resource suppliers, seeking to further their own self-interest and operating within the framework of a highly competitive market system, will simultaneously, as though guided by an “invisible hand,”

promote the public or social interest. For example, we have seen that in a competitive environment, businesses seek to build new and improved products to increase profits. Those enhanced products increase society’s well-being. Businesses also use the least costly combination of resources to produce a specific output because doing so is in their self-interest. To act otherwise would be to forgo profit or even to risk business failure. But, at the same time, to use scarce resources in the least costly way is clearly in the social interest as well. It “frees up” resources to produce something else that society desires.

Self-interest, awakened and guided by the competitive market system, is what induces responses appropriate to the changes in society’s wants. Businesses seeking to make higher profits and to avoid losses, and resource suppliers pursuing greater monetary rewards, negotiate changes in the allocation of resources and end up with the output that society wants. Competition controls or guides self-interest such that self-interest automatically and quite unintentionally furthers the best interest of society. The invisible hand ensures that when firms maximize their profits and resource suppliers maximize their incomes, these groups also help maximize society’s output and income.

Of the various virtues of the market system, three merit reemphasis:

- **Efficiency** The market system promotes the efficient use of resources by guiding them into the production of the goods and services most wanted by society. It forces the use of the most efficient techniques in organizing resources for production, and it encourages the development and adoption of new and more efficient production techniques.
- **Incentives** The market system encourages skill acquisition, hard work, and innovation. Greater work skills and effort mean greater production and higher incomes, which usually translate into a higher standard of living. Similarly, the assuming of risks by entrepreneurs can result in substantial profit incomes. Successful innovations generate economic rewards.
- **Freedom** The major noneconomic argument for the market system is its emphasis on personal freedom. In contrast to central planning, the market system coordinates economic activity without coercion. The market system permits—indeed, it thrives on—freedom of enterprise and choice. Entrepreneurs and workers are free to further their own self-interest, subject to the rewards and penalties imposed by the market system itself.

## The Demise of the Command Systems

Our discussion of how a market system answers the five fundamental questions provides insights on why command systems of the Soviet Union, eastern Europe, and China (prior to its market reforms) failed. Those systems encountered two insurmountable problems.

### The Coordination Problem

The first difficulty was the coordination problem. The central planners had to coordinate the millions of individual decisions by consumers, resource suppliers, and businesses. Consider the setting up of a factory to produce tractors. The central planners had to establish a realistic annual production target, for example, 1000 tractors. They then had to make available all the necessary inputs—labor, machinery, electric power, steel, tires, glass, paint, transportation—for the production and delivery of those 1000 tractors.

Because the outputs of many industries serve as inputs to other industries, the failure of any single industry to achieve its output target caused a chain reaction of repercussions. For example, if iron mines, for want of machinery or labor or transportation, did not supply the steel industry with the required inputs of iron ore, the steel mills were unable to fulfill the input needs of the many industries that depended on steel. Those steel-using industries (such as tractor, automobile, and transportation) were unable to fulfill their planned production goals. Eventually the chain reaction spread to all firms that used steel as an input and from there to other input buyers or final consumers.

The coordination problem became more difficult as the economies expanded. Products and production processes grew more sophisticated, and the number of industries requiring planning increased. Planning techniques that worked for the simpler economy proved highly inadequate and inefficient for the larger economy. Bottlenecks and production stoppages became the norm, not the exception. In trying to cope, planners further suppressed product variety, focusing on one or two products in each product category.

A lack of a reliable success indicator added to the coordination problem in the Soviet Union and China (prior to its market reforms). We have seen that market economies rely on profit as a success indicator. Profit depends on consumer demand, production efficiency, and product quality. In contrast, the major success indicator for the command economies usually was a quantitative production target that the central planners assigned. Production costs, product quality, and product mix were secondary

considerations. Managers and workers often sacrificed product quality and variety because they were being awarded bonuses for meeting quantitative, not qualitative, targets. If meeting production goals meant sloppy assembly work and little product variety, so be it.

It was difficult at best for planners to assign quantitative production targets without unintentionally producing distortions in output. If the plan specified a production target for producing nails in terms of *weight* (tons of nails), the enterprise made only large nails. But if it specified the target as a *quantity* (thousands of nails), the firm made all small nails, and lots of them! That is precisely what happened in the centrally planned economies.

### The Incentive Problem

The command economies also faced an incentive problem. Central planners determined the output mix. When they misjudged how many automobiles, shoes, shirts, and chickens were wanted at the government-determined prices, persistent shortages and surpluses of those products arose. But as long as the managers who oversaw the production of those goods were rewarded for meeting their assigned production goals, they had no incentive to adjust production in response to the shortages and surpluses. And there were no fluctuations in prices and profitability to signal that more or less of certain products was desired. Thus, many products were unavailable or in short supply, while other products were overproduced and sat for months or years in warehouses.

The command systems of the Soviet Union and China before its market reforms also lacked entrepreneurship. Central planning did not trigger the profit motive, nor did it reward innovation and enterprise. The route for getting ahead was through participation in the political hierarchy of the Communist Party. Moving up the hierarchy meant better housing, better access to health care, and the right to shop in special stores. Meeting production targets and maneuvering through the minefields of party politics were measures of success in “business.” But a definition of business success based solely on political savvy was not conducive to technological advance, which is often disruptive to existing products, production methods, and organizational structures.

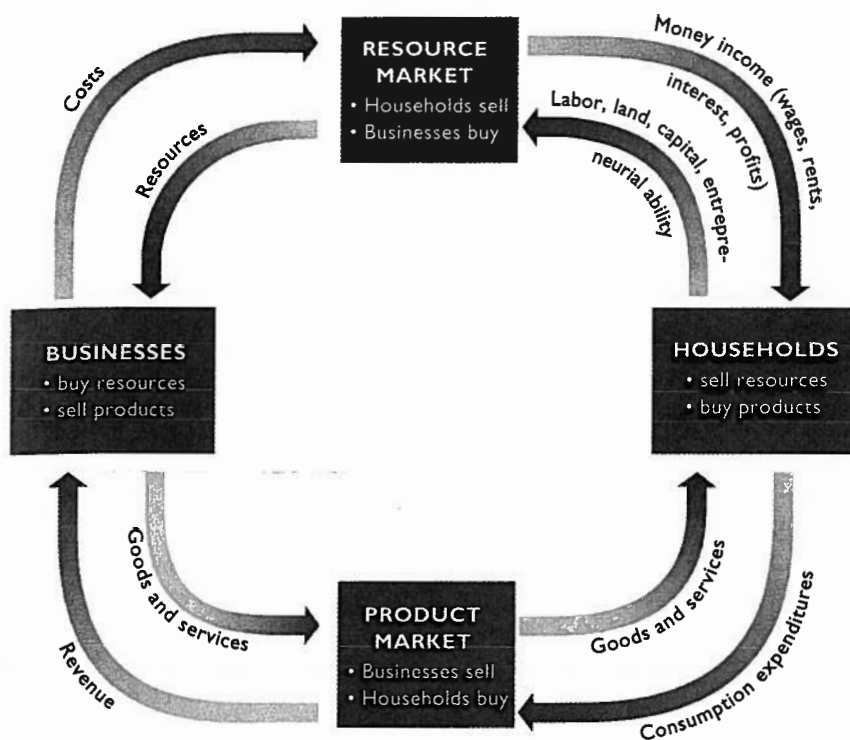


O 2.4

Circular flow diagram

## The Circular Flow Model

The dynamic market economy creates continuous, repetitive flows of goods and services, resources, and money. The **circular flow diagram**, shown in Figure 2.2 (Key



**FIGURE 2.2 The circular flow diagram.** Resources flow from households to businesses through the resource market, and products flow from businesses to households through the product market. Opposite these real flows are monetary flows. Households receive income from businesses (their costs) through the resource market, and businesses receive revenue from households (their expenditures) through the product market.

### QUICK QUIZ 2.2

- The resource market is the place where:
  - households sell products and businesses buy products.
  - businesses sell resources and households sell products.
  - households sell resources and businesses buy resources (or the services of resources).
  - businesses sell resources and households buy resources (or the services of resources).
- Which of the following would be determined in the product market?
  - a manager's salary.
  - the price of equipment used in a bottling plant.
  - the price of 80 acres of farmland.
  - the price of a new pair of athletic shoes.
- In this circular flow diagram:
  - money flows counterclockwise.
  - resources flow counterclockwise.
  - goods and services flow clockwise.
  - households are on the selling side of the product market.
- In this circular flow diagram:
  - households spend income in the product market.
  - firms sell resources to households.
  - households receive income through the product market.
  - households produce goods.

Answers: 1. c; 2. d; 3. b; 4. a

Graph), illustrates those flows. Observe that in the diagram we group private decision makers into *businesses* and *households* and group markets into the *resource market* and the *product market*.

## Resource Market

The upper half of the circular flow diagram represents the **resource market**: the place where resources or the services of resource suppliers are bought and sold. In the

resource market, households sell resources and businesses buy them. Households (that is, people) own all economic resources either directly as workers or entrepreneurs or indirectly through their ownership of business corporations. They sell their resources to businesses, which buy them because they are necessary for producing goods and services. The funds that businesses pay for resources are costs to businesses but are flows of wage, rent, interest, and profit income to the households. Productive resources

### Economist Donald Boudreaux Marvels at the Way the Market System Systematically and Purposefully Arranges the World's Tens of Billions of Individual Resources.

In *The Future and Its Enemies*, Virginia Postrel notes the astonishing fact that if you thoroughly shuffle an ordinary deck of 52 playing cards, chances are practically 100 percent that the resulting arrangement of cards has never before existed. *Never*. Every time you shuffle a deck, you produce an arrangement of cards that exists for the first time in history.

The arithmetic works out that way. For a very small number of items, the number of possible arrangements is small. Three items, for example, can be arranged only six different ways. But the number of possible arrangements grows very large very quickly. The number of different ways to arrange five items is 120 . . . for ten items it's 3,628,800 . . . for fifteen items it's 1,307,674,368,000.

The number of different ways to arrange 52 items is  $8.066 \times 10^{67}$ . This is a *big* number. No human can comprehend its enormity. By way of comparison, the number of possible ways to arrange a mere 20 items is 2,432,902,008,176,640,000—a number larger than the total number of seconds that have elapsed since the beginning of time ten billion years ago—and this number is Lilliputian compared to  $8.066 \times 10^{67}$ .

What's the significance of these facts about numbers? Consider the number of different resources available in the world—my labor, your labor, your land, oil, tungsten, cedar, coffee beans, chickens, rivers, the Empire State Building, [Microsoft] Windows, the wharves at Houston, the classrooms at Oxford, the airport at Miami, and on and on and on. No one can possibly count all of the different productive resources available for our use. But we can be sure that this number is at least in the tens of billions.

When you reflect on how incomprehensibly large is the number of ways to arrange a deck containing a mere 52 cards, the mind boggles at the number of different ways to arrange all the world's resources.

If our world were random—if resources combined together haphazardly, as if a giant took them all into his hands and tossed them down like so many [cards]—it's a virtual certainty that the resulting combination of resources would be useless. Unless this chance arrangement were quickly rearranged according to some productive logic, nothing worthwhile would be produced. We would all starve to death. Because only a tiny fraction of possible arrangements serves human ends, any arrangement will be useless if it is chosen randomly or with inadequate knowledge of

how each and every resource might be productively combined with each other.

And yet, we witness all around us an arrangement of resources that's productive and serves human goals. Today's arrangement of resources might not be perfect, but it is vastly superior to most of the trillions upon trillions of other possible arrangements.

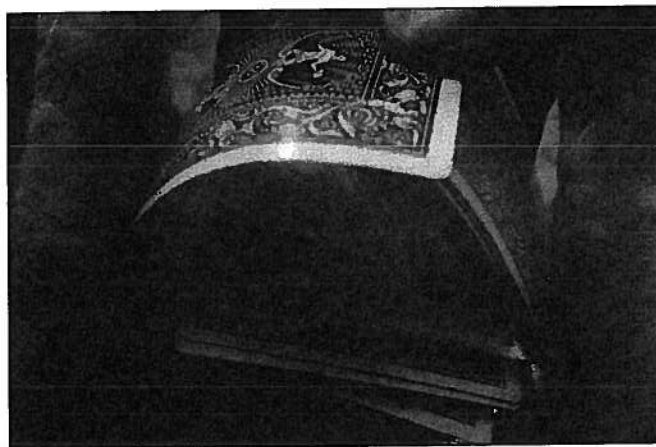
How have we managed to get one of the minuscule number of arrangements that works?

The answer is private property—a social institution that encourages mutual accommodation.

Private property eliminates the possibility that resource arrangements will be random, for each resource owner chooses a course of action only if it promises rewards to the owner that exceed the rewards promised by all other available courses.

[The result] is a breathtakingly complex and productive arrangement of countless resources. This arrangement emerged over time (and is still emerging) as the result of billions upon billions of individual, daily, small decisions made by people seeking to better employ their resources and labor in ways that other people find helpful.

Source: Abridged from Donald J. Boudreaux, "Mutual Accommodation," *Ideas on Liberty*, May 2000, pp. 4–5. Reprinted with permission.



therefore flow from households to businesses, and money flows from businesses to households.

## Product Market

Next consider the lower part of the diagram, which represents the **product market**: the place where goods and services produced by businesses are bought and sold. In the product market, businesses combine resources to produce and sell goods and services. Households use the (limited) income they have received from the sale of resources to buy goods and services. The monetary flow of consumer spending on goods and services yields sales revenues for businesses. Businesses compare those revenues

to their costs in determining profitability and whether or not a particular good or service should continue to be produced.

The circular flow model depicts a complex, interrelated web of decision making and economic activity involving businesses and households. For the economy, it is the circle of life. Businesses and households are both buyers and sellers. Businesses buy resources and sell products. Households buy products and sell resources. As shown in Figure 2.2, there is a counterclockwise *real flow* of economic resources and finished goods and services and a clockwise *money flow* of income and consumption expenditures.

## Summary

1. The market system and the command system are the two broad types of economic systems used to address the economizing problem. In the market system (or capitalism), private individuals own most resources, and markets coordinate most economic activity. In the command system (or socialism or communism), government owns most resources, and central planners coordinate most economic activity.
2. The market system is characterized by the private ownership of resources, including capital, and the freedom of individuals to engage in economic activities of their choice to advance their material well-being. Self-interest is the driving force of such an economy, and competition functions as a regulatory or control mechanism.
3. In the market system, markets, prices, and profits organize and make effective the many millions of individual economic decisions that occur daily.
4. Specialization, use of advanced technology, and the extensive use of capital goods are common features of market systems. Functioning as a medium of exchange, money eliminates the problems of bartering and permits easy trade and greater specialization, both domestically and internationally.
5. Every economy faces five fundamental questions: (a) What goods and services will be produced? (b) How will the goods and services be produced? (c) Who will get the goods and services? (d) How will the system accommodate change? (e) How will the system promote progress?
6. The market system produces products whose production and sale yield total revenue sufficient to cover total cost. It does not produce products for which total revenue continuously falls short of total cost. Competition forces firms to use the lowest-cost production techniques.
7. Economic profit (total revenue minus total cost) indicates that an industry is prosperous and promotes its expansion. Losses signify that an industry is not prosperous and hasten its contraction.
8. Consumer sovereignty means that both businesses and resource suppliers are subject to the wants of consumers. Through their dollar votes, consumers decide on the composition of output.
9. The prices that a household receives for the resources it supplies to the economy determine that household's income. This income determines the household's claim on the economy's output. Those who have income to spend get the products produced in the market system.
10. By communicating changes in consumer tastes to entrepreneurs and resource suppliers, the market system prompts appropriate adjustments in the allocation of the economy's resources. The market system also encourages technological advance and capital accumulation, both of which raise a nation's standard of living.
11. Competition, the primary mechanism of control in the market economy, promotes a unity of self-interest and social interests. As directed by an invisible hand, competition harnesses the self-interest motives of businesses and resource supplier to further the social interest.
12. The command systems of the Soviet Union and pre-reform China met their demise because of coordination difficulties under central planning and the lack of a profit incentive. The coordination problem resulted in bottlenecks, inefficiencies, and a focus on a limited number of products. The incentive problem discouraged product improvement, new product development, and entrepreneurship.
13. The circular flow model illustrates the flows of resources and products from households to businesses and from businesses to households, along with the corresponding monetary flows. Businesses are on the buying side of the resource market and the selling side of the product market. Households are on the selling side of the resource market and the buying side of the product market.