

## The Market System

Chapter 4 describes the major characteristics of the market system and offers a detailed explanation of how it works.

The first part of Chapter 4 describes the *ideological* and *institutional* characteristics of the market system. In this system, most of the resources are owned by citizens, who are free to use them as they wish in their own self-interest. Prices and markets express the self-interests of resource owners, consumers, and business firms. Competition regulates self-interest—to prevent the self-interest of any person or any group from working to the disadvantage of the economy and to make self-interests work for the benefit of the entire economy. Government plays an active, but limited, role in a market economy.

Three other characteristics are also found in a market economy. They are the employment of large amounts of *capital*, the development of *specialization*, and the *use of money*. Economies use capital and engage in specialization because this is a more efficient use of their resources; it results in larger total output and the greater satisfaction of wants. When workers, business firms, and regions within an economy specialize, they become dependent on each other for the goods and services they do not produce for themselves. To obtain these goods and services they must engage in trade. Trade is made more convenient by using money as a medium of exchange.

The second part of Chapter 4 describes the operation of the market system. There are *Four Fundamental Questions* that any economic system must answer in its attempt to use its scarce resources to satisfy its material wants. The four questions or problems are: (1) What will be produced? (2) How will the output be produced? (3) Who is to receive the output? (4) Can the system adapt to change?

The explanation of how the market system finds answers to the Four Fundamental Questions is only an approximation—a simplified version or model—of the methods actually employed by the U.S. economy and other market economies. Yet this simple model, like all good models, contains enough realism to be truthful and is general enough to be understandable. If the aims of this chapter are accomplished, you can begin to understand the market system and methods our economy uses to solve the economizing problem presented in Chapter 2.

### ■ CHECKLIST

When you have studied this chapter you should be able to

- ☐ Identify the nine important characteristics of the market system.
- ☐ Describe the significance of property rights in the market system.
- ☐ Distinguish between freedom of enterprise and freedom of choice.
- ☐ Explain why self-interest is a driving force of the market system.
- ☐ Identify two features of competition.
- ☐ Explain the roles of markets and prices.
- ☐ Explain why the market system relies on technology and capital goods, and also why the production of capital goods entails roundabout production.
- ☐ Discuss how two types of specialization improve efficiency in the market system.
- ☐ Describe the advantages of money over barter for the exchange of goods and services in a market economy.
- ☐ Describe the size and role of government in the market system.
- ☐ List the Four Fundamental Questions to answer about the operation of a market economy.
- ☐ Explain how a market system determines what goods and services will be produced.
- ☐ Distinguish between normal profit and economic profit.
- ☐ Predict what will happen to the price charged by and the output of an expanding and a declining industry, and explain why these events will occur.
- ☐ Explain how consumer sovereignty and dollar votes work in a market economy.
- ☐ Describe market restraints on economic freedom.
- ☐ Explain how goods and services will be produced in a market system.
- ☐ Find the least costly combination of resources needed for production when given the technological data and the prices of the resources.
- ☐ Explain how a market system determines who will get the goods and services it produces.
- ☐ Describe the guiding function of prices to accommodate change in the market system.

- ☐ Explain how the market system initiates change by fostering technological advances and capital accumulation.
- ☐ State how the "invisible hand" in the market system tends to promote public or social interests.
- ☐ List three virtues of the market system.

## ■ CHAPTER OUTLINE

1. The market system has the following nine characteristics:

- a. Private individuals and organizations own and control their property resources by means of the institution of private property.
- b. These individuals and organizations possess both the freedom of enterprise and the freedom of choice.
- c. Each of them is motivated largely by self-interest.
- d. Competition is based on the independent actions of buyers and sellers. They have the freedom to enter or leave markets. This competition spreads economic power and limits its potential abuse.
- e. Markets and prices are used to communicate and coordinate the decisions of buyers and sellers.
- f. The market system employs complicated and advanced methods of production, new technology, and large amounts of capital equipment to produce goods and services efficiently.
- g. It is a highly specialized economy. Human and geographic specialization increases the productive efficiency of the economy.
- h. It uses money exclusively to facilitate trade and specialization.
- i. Government has an active but limited role.

2. The system of prices and markets and households' and business firms' choices furnish the market economy with answers to **Four Fundamental Questions**.

- a. *What goods and services will be produced?* The demands of consumers for products and the desires of business firms to maximize their profits determine what and how much of each product is produced and its price.
  - b. *How will the goods and services be produced?* The desires of business firms to maximize profits by keeping their costs of production as low as possible guide them to use the most efficient techniques of production and determine their demands for various resources; competition forces them to use the most efficient techniques and ensures that only the most efficient will be able to stay in business.
  - c. *Who will get the goods and services that are produced?* With resource prices determined, the money income of each household is determined; and with product prices determined, the quantity of goods and services these money incomes will buy is determined.
  - d. *How will the market system accommodate change?* The market system is able to accommodate itself to changes in consumer tastes, technology, and resource supplies.
- (1) The desires of business firms for maximum profits and competition lead the economy to make the appropriate adjustments in the way it uses its resources.

(2) Competition and the desire to increase profits promotes better techniques of production and capital accumulation.

3. Competition in the economy compels firms seeking to promote their own interests to promote (as though led by an "invisible hand") the best interests of society as a whole.

- a. Competition results in an allocation of resources appropriate to consumer wants, production by the most efficient means, and the lowest possible prices.
- b. Three noteworthy merits of the market system are
  - (1) The *efficient* use of resources
  - (2) The *incentive* the system provides for productive activity
  - (3) The personal *freedom* allowed participants as consumers, producers, workers, or investors.

## ■ HINTS AND TIPS

1. The first section of the chapter describes nine characteristics and institutions of a market system. After reading the section, check your understanding by listing the nine points and writing a short explanation of each one.

2. The section on the "Market System at Work" is both the most important and the most difficult part of the chapter. A market economy must answer *Four Fundamental Questions*. Detailed answers to the four questions are given in this section of the chapter. If you examine each one individually and in the order in which it is presented, you will more easily understand how the market system works. (Actually, the market system finds the answers simultaneously, but make your learning easier for now by considering them one by one.)

3. Be sure to understand the *importance* and *role* of each of the following in the operation of the market system: (1) the guiding function of prices, (2) the profit motive of business firms, (3) the entry into and exodus of firms from industries, (4) the meaning of competition, and (5) consumer sovereignty.

## ■ IMPORTANT TERMS

private property	economic cost
freedom of choice	normal profit
freedom of enterprise	economic profit
self-interest	expanding industry
competition	declining industry
roundabout production	consumer sovereignty
specialization	dollar votes
division of labor	derived demand
medium of exchange	guiding function of prices
barter	creative destruction
money	"invisible hand"
Four Fundamental Questions	