

THE MARKET SYSTEM AND THE PRIVATE SECTOR

FUNDAMENTAL QUESTIONS

1. In a market system, who decides what goods and services are produced and how they are produced, and who obtains the goods and services that are produced?

In a market system, consumers decide what goods and services are produced by means of their purchases. If consumers want more of a good or service and are willing to pay for it, demand increases and the price of the good or service increases. Higher profits then attract new producers to the industry. If consumers want less of an item, demand decreases and the price of the item decreases. Resources are then attracted away from the industry.

The search for profits dictates how goods and services are produced. Firms must use the least-cost combination of resources or be driven out of business.

Income and prices determine who gets what. Income is determined by ownership of resources: those who own highly valued resources get more income. Output then is allocated to whoever is willing to pay the price.

2. What is a household, and what is household spending?

A **household** consists of one or more persons who occupy a unit of housing. Household spending is called **consumption** and is the largest component of total spending in the economy.

3. What is a business firm, and what is business spending?

A **business firm** is a business organization controlled by a single management. Business firms can be organized as **sole proprietorships**, **partnerships**, or **corporations**. Business spending by firms is called **investment** and consists of expenditures of capital goods that are used in producing goods and services.

4. How does the international sector affect the economy?

The nations of the world can be divided into two categories: **industrial countries** and **developing countries**. The economies of industrial nations are highly interdependent. As business conditions change in one country, business firms shift resources among countries so that economic conditions in one country spread to other countries.

The international trade of the United States occurs primarily with the industrial countries, especially Canada and Japan. **Exports** are products the United States sells to foreign countries. **Imports** are products it buys from other countries.

5. How do the three private sectors—households, businesses, and the international sector—interact in the economy?

Households own the **factors of production** and sell them to firms in return for **income**. Business firms combine the factors of production into goods and services and sell them to households and the international sector in exchange for **revenue**. The international sector buys and sells goods and services to business firms. The **circular flow diagram** illustrates these relationships.

Key Terms

consumer sovereignty
private sector
public sector
household
consumption
business firm

sole proprietorship
partnership
corporation
multinational business
investment
imports

exports
trade surplus
trade deficit
net exports
financial intermediaries
circular flow diagram

Quick-Check Quiz

Section 1: The Market System

- In a market system, _____ decide what is produced.
 - producers
 - consumers
 - politicians
 - government authorities
 - central planning boards
- Many fitness educators are advocating step exercise as a way to improve cardiovascular fitness. Special boxes are used by participants, who step up and down, from side to side, and so on. If these boxes catch on, the _____, them will _____, their price will _____, and _____ boxes will be produced.
 - demand for; increase; increase; more
 - supply of; increase; increase; more
 - supply of; increase; decrease; more
 - demand for; increase; decrease; more
 - supply of; increase; decrease; fewer
- Assume that land costs \$1 per unit, labor costs \$3 per unit, and capital costs \$2 per unit. All of the following combinations of resources produce 35 units of good X. How should good X be produced?
 - 3 units of land, 4 units of labor, and 2 units of capital
 - 2 units of land, 1 unit of labor, and 2 units of capital
 - 5 units of land, 1 unit of labor, and 2 units of capital
 - 1 unit of land, 2 units of labor, and 3 units of capital
 - 2 units of land, 2 units of labor, and 3 units of capital

4. With the growth of the Internet, people are spending more time visiting websites and less time watching television. Which of the following statements correctly describes this change?
- The demand for television programs has increased, and the demand for website designers has increased.
 - The demand for television programs has decreased, and the demand for website designers has increased.
 - The demand for television programs has decreased, and the demand for website designers has decreased.
 - The demand for television actors has increased, and the demand for computers has increased.
 - The demand for television actors has decreased, and the demand for computers has decreased.

Section 2: Households

- Householders _____ years old make up the largest number of households.
 - 15 to 24
 - 25 to 34
 - 35 to 44
 - 45 to 54
 - 55 to 64
- Householders _____ years old have the largest median annual income.
 - 15 to 24
 - 25 to 34
 - 35 to 44
 - 45 to 54
 - 55 to 64
- The largest percentage of households consist of _____ person(s).
 - one
 - two
 - three
 - four
 - five
- Household spending, or consumption, is the _____ component of total spending in the economy.
 - largest
 - second largest
 - third largest
 - fourth largest
 - smallest

5. There are five families living in the small town of North Mayberry. Family A's annual income is \$20,000. Family B's annual income is \$30,000, Family C's annual income is \$50,000, Family D's annual income is \$200,000, and Family E's annual income is \$500,000. What is the median income in North Mayberry?
- \$800,000
 - \$160,000
 - \$20,000
 - \$500,000
 - \$50,000

Section 3: Business Firms

1. In _____ the owner of the business is responsible for all the debts incurred by the business and may have to pay those debts from his or her personal wealth.
- sole proprietorships
 - partnerships
 - corporations
 - sole proprietorships and partnerships
 - sole proprietorships, partnerships, and corporations
2. _____ are the most common form of business organization, but _____ account for the largest share of total revenues.
- Sole proprietorships; partnerships
 - Sole proprietorships; corporations
 - Partnerships; corporations
 - Corporations; sole proprietorships
 - Partnerships; sole proprietorships
3. *Investment* as used in the text is
- a financial transaction, like buying bonds or stock.
 - business spending on capital goods.
 - equal to about one-half of household spending.
 - a relatively stable form of spending.
 - All of the above describe *investment*.

Section 4: The International Sector

1. The United States tends to import primary products such as agricultural produce and minerals from _____ countries.
- low-income
 - medium-income
 - high-income
 - industrial
 - developing

2. About one-third of U.S. imports and more than a third of U.S. exports came from trade between the United States and
 - a. the United Kingdom and Germany.
 - b. eastern Europe.
 - c. Canada and Japan.
 - d. oil exporters.
 - e. developing countries.

3. A trade surplus occurs when
 - a. net exports are positive.
 - b. net exports are negative.
 - c. a country buys more from other countries than it sells to other countries.
 - d. imports exceed exports.
 - e. industrial countries sell to developing countries.

4. Low-income countries are concentrated heavily in
 - a. Central America.
 - b. South America.
 - c. North America.
 - d. Africa and Asia.
 - e. western Europe.

5. Which of the following statements is false?
 - a. Imports are products that a country buys from another country.
 - b. Exports are products that a country sells to another country.
 - c. Net exports equal exports minus imports.
 - d. Net exports equal imports minus exports.
 - e. A trade surplus is the same as positive net exports.

Section 5: Linking the Sectors

1. Which of the following statements is false?
 - a. Households sell the factors of production in exchange for money payments.
 - b. Firms buy the factors of production from households.
 - c. The value of output must equal the value of income.
 - d. The value of input must equal the value of household income.
 - e. Money that is saved by households reenters the economy in the form of investment spending.

2. _____ own(s) the factors of production.
 - a. Corporations
 - b. Partnerships
 - c. The international sector
 - d. State and local governments
 - e. Households

Practice Questions and Problems

Section 1: The Market System

1. The _____ system is an economic system in which supply and demand determine what goods and services are produced and the prices at which they are sold.
2. To clarify the operation of the national economy, economists usually group individual buyers and sellers into three sectors: _____, _____, and _____.
3. _____ is the authority of consumers to determine, by means of their purchases, what is produced.
4. Resources tend to flow from _____-valued uses to _____-valued uses as firms seek to make a profit.
5. When consumers' tastes change in favor of a good, _____ (demand, supply) _____ (increases, decreases) and the _____ (higher, lower) price attracts new firms to the production of that good.
6. When consumers' tastes change away from a good, _____ (demand, supply) _____ (increases, decreases) and the _____ (higher, lower) price causes firms to reduce production of that good.
7. In a market system, _____ dictate what is produced by means of their purchases of goods and services.

Section 2: Households

1. A(n) _____ consists of one or more persons who occupy a unit of housing.
2. Household spending is called _____.
3. Householders between _____ and _____ years old have the largest median incomes.
4. A household is most likely to consist of _____ persons.

Section 3: Business Firms

1. A(n) _____ is a business organization controlled by a single management.
2. A(n) _____ is a business owned by one person.
3. A(n) _____ is a business owned by two or more individuals who share both the profits of the business and the responsibility for the firm's losses.
4. A(n) _____ is a legal entity owned by shareholders whose liability for the firm's losses is limited to the value of the stock they own.
5. A(n) _____ business is a firm that owns and operates producing units in foreign countries.
6. In the United States, the most common form of business organization is the _____.
7. _____ is the expenditure by business firms for capital goods.
8. _____ account for the largest percentage of business revenue.

Section 4: The International Sector

1. The _____ is an international organization that makes loans to developing countries.
2. Low-income economies are heavily concentrated in _____ and _____.
3. Products that a country buys from another country are called _____.
4. Products that a country sells to another country are called _____.
5. The United States trades the most with two countries, _____ and _____.
6. A trade _____ exists when exports exceed imports.
7. A trade _____ exists when imports exceed exports.
8. _____ equal exports minus imports.
9. _____ net exports signal a trade surplus; _____ net exports signal a trade deficit.

Section 5: Linking the Sectors

1. List the three factors of production.

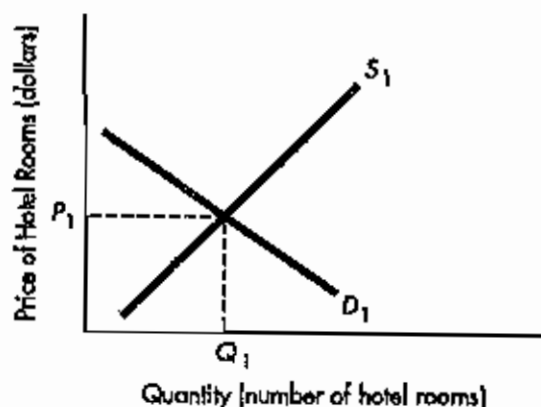
2. _____ own the factors of production.
3. The _____ is a model showing the flow of output and income from one sector of the economy to another.

Thinking About and Applying the Market System and the Private Sector

I. The Demand for Services in the Travel Industry

Consider the economic incentives for travel firms to add services. These services add costs to the expenses of the firm but may also increase demand. If the demand shift is greater than the supply shift, it pays the firm to add the service. If the supply shift is greater than the demand shift, it does not pay the firm to add the service.

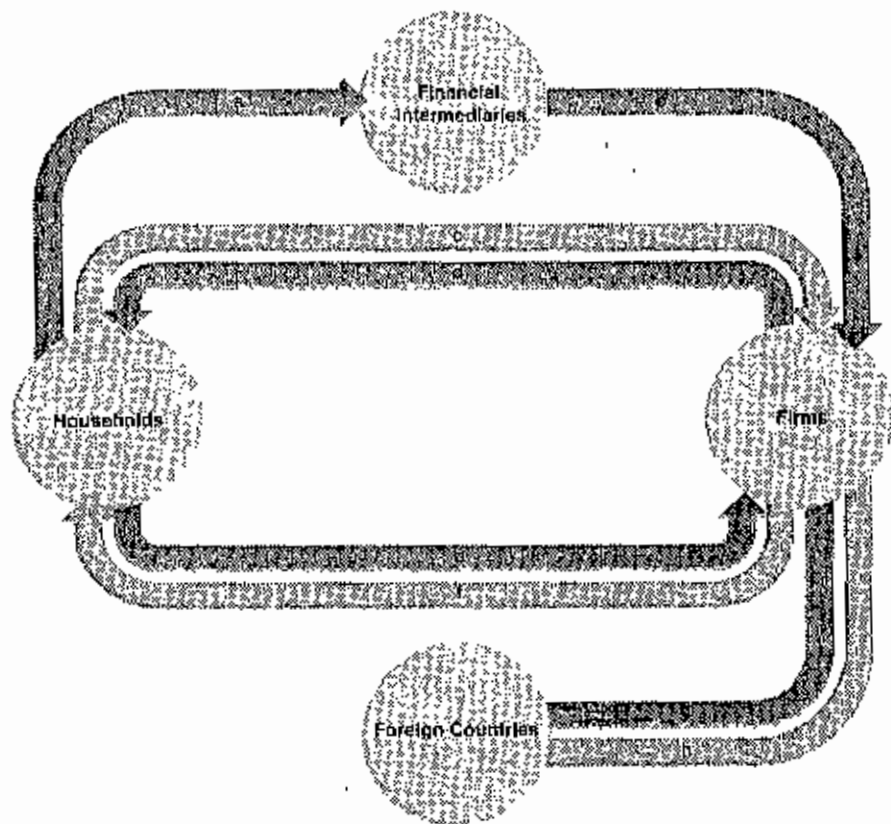
1. The graph below represents the demand for hotel rooms without daily delivery of newspapers. Plot new demand and supply curves (D_2 and S_2) that show the effects of providing daily newspapers. Construct your curves to make it profitable for hotels to provide the newspapers.



2. What happens to the price of hotel rooms?

II. The Circular Flow Diagram

Use the diagram below to see if you understand how the three sectors of the economy are linked together. In the blanks below, fill in the appropriate labels. Money flows are represented by light gray lines. Flows of physical goods and services are represented by dark gray lines.



a. _____

b. _____

c. _____

d. _____

e. _____

f. _____

g. _____

h. _____



5. Suppose you were an English merchant in the 1600s, trying to start a business shipping cargoes of raw materials to England from the newly established English colonies around the world and shipping finished goods back from England to the colonies. The business will be risky; many cargo ships sink due to storms or navigation hazards.

You need to raise money from many investors to start the business. Think about the differences between partnerships and corporations and explain why setting up the business as a corporation would make it much easier to attract investors to your business.

If your instructor assigns these problems, write your answers above, then tear out this page and hand it in.

Answers

Quick-Check Quiz

Section 1: The Market System

1. b; 2. a; 3. b; 4. b

If you missed any of these questions, you should go back and review Section 1 in Chapter 4.

Section 2: Households

1. c; 2. d; 3. b; 4. a; 5. e

If you missed any of these questions, you should go back and review Section 2 in Chapter 4.

Section 3: Business Firms

1. d; 2. b; 3. b

If you missed any of these questions, you should go back and review Section 3 in Chapter 4.

Section 4: The International Sector

1. e; 2. c; 3. a; 4. d; 5. d

If you missed any of these questions, you should go back and review Section 4 in Chapter 4.

Section 5: Linking the Sectors

1. d; 2. c

If you missed either of these questions, you should go back and review Section 5 in Chapter 4.

Practice Questions and Problems

Section 1: The Market System

1. market
2. households; business firms; the international sector
3. Consumer sovereignty
4. lower, higher
5. demand; increases; higher
6. demand; decreases; lower
7. consumers

Section 2: Households

1. household
2. consumption
3. 45; 54
4. two

Section 3: Business Firms

1. business firm
2. sole proprietorship
3. partnership
4. corporation
5. multinational
6. sole proprietorship
7. Investment
8. Corporations

Section 4: The International Sector

1. World Bank
2. Africa; Asia
3. imports
4. exports
5. Canada; Japan
6. surplus
7. deficit
8. Net exports
9. Positive; negative

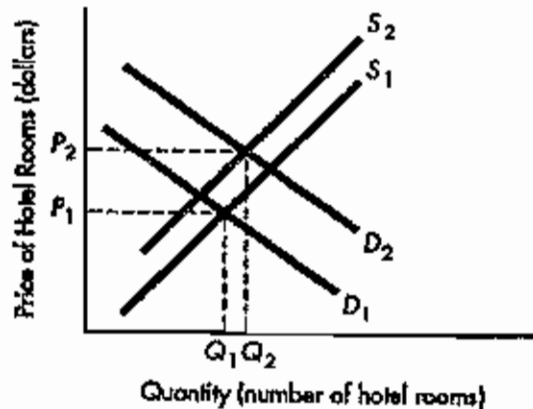
Section 5: Linking the Sectors

1. land
labor
capital
2. Households
3. circular flow diagram

Thinking About and Applying the Market System and the Private Sector

I. The Demand for Services in the Travel Industry

1. If your graph is correct, the demand shift (to the right) is greater than the supply shift (to the left). If the new equilibrium price and quantity are greater than the original equilibrium price and quantity, you've plotted the curves correctly.



2. The price of hotel rooms increases.

II. The Circular Flow Diagram

- a. saving
- b. investment
- c. payments for goods and services
- d. goods and services
- e. resource services
- f. payments for resource services
- g. net exports
- h. payments for net exports