In Section 3, you will
• describe what a market is and how it works
• identify the main features of a market economy
• analyze how the circular flow model represents economic activity in a market economy
• explain the advantages and disadvantages of a market economy

**KEY TERMS**
- private property rights, p. 48
- market, p. 48
- laissez faire, p. 49
- capitalism, p. 49
- voluntary exchange, p. 49
- profit, p. 49
- competition, p. 49
- consumer sovereignty, p. 50
- specialization, p. 50
- circular flow model, p. 52
- product market, p. 52
- factor market, p. 52

**QUICK REFERENCE**
- **Private property rights** are the rights of individuals and groups to own businesses and resources.
- A **market** is any place where people buy and sell goods and services.

**Fundamentals of a Market Economy**

Market economies have several distinct characteristics. Earlier in this chapter you read about the fundamental feature of a market economy—the fact that people’s economic behavior is motivated by self-interest. Self-interested behavior is behind two other features of a market economy. One is **private property rights**, the rights of individuals and groups to own property. In economic terms, **property** means everything that an individual owns. This includes factories, offices, clothes, furniture, house, car, and other belongings; money; and even intellectual property, such as songs or ideas developed for inventions. It also includes the labor individuals provide to earn money to buy what they own.

The other feature that stems from self-interest is the **market**, any place or situation in which people buy and sell resources and goods and services. It may be the farmers’ market on Saturdays in the town square, or it may be an enormous cybermarket on the Internet, such as eBay. Large or small, real or virtual, the market is where people can exchange their private property for someone else’s.

**Private Property Rights** In a market economy, people are free to own and use private property—houses, for example.
FEATURE 1 Private Property and Markets

For markets to operate efficiently, private property rights need to be well defined and actively enforced by law. If you have ever bought a car, you know that an essential part of the transaction is getting possession of the title. You need proof that the person you are buying it from actually owns it and has the right to sell it. Since clear ownership is vital to any sale or exchange, private property rights are necessary to make markets work properly. If buyers could not trust that the sellers actually had the right to offer their products on the market, trade would break down. Further, suppose you are a musician but know that your songs can be downloaded for free, depriving you of your right to exchange what you own for money. In such a situation, it is doubtful that you would be motivated to record music. In protecting private property rights so that producers have motivation and consumers have trust, the government performs an important role in a market economy.

FEATURE 2 Limited Government Involvement

Sometimes the government’s economic role is to stay out of the marketplace. The principle that the government should not interfere in the economy is called **laissez faire**, a French phrase meaning “leave things alone.” The concept of laissez faire is often paired with **capitalism**, an economic system that is based on private ownership of the factors of production. Capitalism, the foundation of market economies, operates on the belief that, on their own, producers will create the goods and services that consumers demand. Therefore, according to laissez faire capitalism, there is no need for government involvement in the marketplace. Laissez faire capitalism is a market economy in its pure form. However, there are no pure market economies—all real-world market economies have some degree of government involvement.

FEATURE 3 Voluntary Exchange in Markets

When a buyer and seller agree to do business together, they engage in a **voluntary exchange**, a trade in which the parties involved anticipate that the benefits will outweigh the cost. Both sides in a voluntary exchange believe that what they are getting is worth more than what they are giving up. In a market economy, most trade is based on an exchange of a product for money rather than for another product.

Self-interest guides voluntary exchanges. Suppose you buy a new guitar. Even though you spend a good part of your savings, your self-interest is served because you’ve wanted this particular model of guitar. The seller’s self-interest is likely served by **profit**, a financial gain from a business transaction. If you pay more for the guitar than the seller did, the seller earns money. In voluntary exchange, then, both sides must believe that they are gaining by trading.

FEATURE 4 Competition and Consumer Sovereignty

Market economies are also characterized by **competition**, the effort of two or more people, acting independently, to get the business of others by offering the best deal. You are able to choose today between a Macintosh and a Windows PC operating system because of the competition in the computer market. In the case of these competing systems, each has somewhat different features but mainly performs the same...
COMPETITION

Where will you buy your computer?

You want to buy a new computer. You could buy a “standard package” from the electronics discount store. The price will be very reasonable, but you won’t be able to customize the software package or the service program. Alternately, you could buy from a computer specialty store. You’ll pay more, but you can choose the extras that you want and the customer support program is excellent.

functions as the other. You are free to decide which you prefer based on whatever combination of price and value appeals to you more. When you buy over-the-counter medications, you can also clearly see the competitive aspect of the market. Often next to a well-known brand-name product you will see a product with the same ingredients, similar packaging, but a different name and lower price. The producers of the lower priced item are competing for the business established by the brand-name product. If the producers of the brand-name product want to keep your business, they must lower their prices or find a way to add some other value.

That’s because you, the consumer, hold the real power in the market place. Consumer sovereignty is the idea that because consumers are free to purchase what they want and to refuse products they do not want, they have the ultimate control over what is produced. Sovereignty means supreme authority, which is what consumers exercise as key economic decision-makers. Let’s look at the over-the-counter medications again. If there were no competition, the brand-name producers could charge higher prices. It would be in their self-interest to charge as much as they possibly could. Competition, however, acts as a control on self-interested behavior, guiding the market toward a balance between higher value and lower prices. Rather than lose your business, the brand-name producers will either lower their prices or raise the value of their product. Because producers must compete for the consumer’s dollar, they have to work at pleasing you, the consumer, while pleasing themselves.

FEATURE 5 Specialization and Markets

A market economy encourages efficient use of resources by allowing people and businesses to specialize in what they do best. Specialization is a situation in which people concentrate their efforts in the areas in which they have an advantage. This allows people to trade what they can most efficiently produce for goods and services.
produced more efficiently by others. Specialization removes the need for households to be self-sufficient, and markets allow households to trade for what they need.

Suppose one adult in your house is a bank teller and another is a welder. Neither banking nor welding needs to happen within your household, but your household does need groceries. By specializing in what they do best—earning money in their jobs—in a market economy these adults are able to trade the dollars they earn for items and services others specialize in. If, however, they had to grow all the family’s food themselves, they’d be less efficient than those who specialized in farming. Also, with each hour spent on growing food they would lose an hour’s worth of wages from their jobs. Specialization, then, leads to higher-quality yet lower-priced products.

**APPLICATION Applying Economic Concepts**

A. Which is more important in determining the format in which recordings are offered by the music industry, new technology or consumer sovereignty? Explain.
Circular Flow in Market Economies

**KEY CONCEPTS**

How do all these fundamental characteristics combine to allow a market economy to function? Economists have developed a model to help them answer this question. Called the circular flow model, it visualizes how all interactions occur in a market economy. The model represents the two key economic decision makers in a market economy—households, which are made up of individuals like you, and businesses. It also shows the two markets where households and businesses meet—that for goods and services, and that for resources. (See Figure 2.4 on the next page.)

**Product Markets**

The market for goods and services is called the product market. This is the market you probably know best. The product market isn’t a place as much as it is a set of activities. Whenever or wherever individuals purchase goods or services—at a local mall, a dentist’s office, the phone company, or an online service selling concert tickets—they are doing so in the product market. The suppliers of the product market are businesses, which offer their goods or services for sale and use the money they earn from the sales to keep their businesses going.

**Factor Markets**

To run a business, firms must, in turn, purchase what they need from the factor market, the market for the factors of production—land, labor, capital, and entrepreneurship. Individuals own all the factors of production. They own some factors of production outright, such as their own labor and entrepreneurship. Others they own indirectly as stockholders in businesses. In the factor market, businesses are the customers and individuals are the producers. A restaurant buys your labor as a server, for example, to serve meals prepared by chefs whose labor they have also bought. The chefs make the meals from products bought from farmers who own the fields and farm equipment.

**Circular Flow**

This set of interactions between businesses and individuals is illustrated in Figure 2.4 on the next page. On the left and right of the model, you can see the two main economic decision makers, businesses and households. At the top and bottom are the two main markets, product and factor. The green arrows represent the flow of money. The blue arrows represent the flow of resources and products.

**QUICK REFERENCE**

The circular flow model is a tool that economists use to understand how market economies operate.

The product market is the market where goods and services are bought and sold.

The factor market is the market for the factors of production—land, labor, capital, and entrepreneurship.
Find the “Households” box at the right side of the chart. If you follow the green arrow, you see that individuals spend money in the product market to buy goods and services. From the product market, the money goes to businesses as revenue. The businesses spend this in the factor market, paying for the land, labor, capital, and entrepreneurship needed to produce goods and services. The receivers of that money are individuals who own all the factors of production. With the money they receive, individuals can make more purchases in the product market, and so the cycle continues.

If you look at the blue arrows, you can follow the route of the resources and products in the circular flow model. Once again, start with individuals. They sell their land, capital, labor, and entrepreneurship in the factor market. Follow the arrows to see that these factors of production are bought by businesses. The businesses then use these productive resources to make goods and services. The goods and services are then sold in the product market and flow to individuals who purchase them.

**APPLICATION**  Interpreting Economic Models

B. Think of a good or a service you have recently bought. Using the circular flow model as a guide, write an explanation of the impact of your purchase on the economy.
Impact of Market Economies

**KEY CONCEPTS**

Between the late 1940s and the early 1990s, between one-quarter and one-third of the world’s population lived under command economic systems. The Soviet Union and its Eastern European neighbors, China and much of Southeast Asia, Cuba, and North Korea all had centrally planned economies. However, with the collapse of communism in the early 1990s, most of these countries have adopted some form of market economy. Also, as you read in Section 2, even those that have clung to communism and central planning have introduced market-economy measures. Why were these countries so ready to embrace the market system?

**Advantages**

On November 9, 1989, the Berlin Wall, a symbol of the division between the communist and democratic worlds, was finally opened. Over the next few days, hundreds of thousands of East Germans began pouring into West Germany through gates and improvised breaches in the wall. What drew these jubilant East Germans to the west? For most of them, the answer was freedom.

**Economic and Political Freedom** Freedom is one of the chief advantages of a market economy. A market economy requires that individuals be free to make their own economic choices, since it depends on the consumer’s right to buy or refuse products to determine what will be produced. Individuals are also free to develop their interests and talents in work they find satisfying, rather than being assigned to jobs.

Also, since the government does not use a heavy hand to control the economy, the political process can be much freer, with a diversity of viewpoints and open elections. Government bureaucracy is generally less cumbersome and costly in a market economy than in a command economy, since there are fewer areas of government involvement. A market economy also can be responsive to changes in conditions and accommodate those changes quickly.

Further, individuals in local communities are free to make their own economic choices without the interference of the government. These individuals’ better knowledge of the resources and potential of their area leads to better economic decisions and greater productivity.

**Profit** The profit motive, a key feature of a market economy, insures that resources will be allocated efficiently, since inefficiencies would result in lower profits. It also serves as a reward for hard work and innovation. Knowing you can earn money...
if you come up with a good idea is an incentive to do so, and the more good ideas people have, the more the economy grows. The incentive to come up with good ideas is related to another advantage of a market economy: it encourages competition, letting consumers have the final say. Competition leads to higher-quality products at lower prices. It also helps to create a diverse product market.

Disadvantages

Market economies, however, have disadvantages as well. In a pure market economy, the economic good of the individual is the primary focus. A pure market economy has no mechanism for providing public goods and services, such as national defense, because it would not be profitable from a strictly economic viewpoint to do so.

Another disadvantage is that a pure market economy cannot provide security to those who, because of sickness or age, cannot be economically productive. Nor can it prevent the unequal distribution of wealth, even though that gap may be the result of unequal opportunities.

The industrial boom in the United States in the late 1800s and early 1900s illustrates the problems that can develop in a market economy with little government regulation. During this time, a few business leaders became very rich. At the same time, most of those who worked for these leaders were paid low—but increasing—wages. Further, most business leaders did little at the time to address the negative consequences of industrialization such as pollution. Issues like these led most industrialized societies to adopt some level of government involvement in the economy. The result was economic systems that mix elements of market and command economies. In Section 4, you’ll learn more about such mixed economies.

APPLICATION Analyzing Causes

C. Why did many societies feel it necessary to adopt some level of government involvement in market economies?
Comparing and Contrasting Economic Systems

Comparing means looking at the similarities and differences between two or more things. Contrasting means examining only the differences between them. To understand economic systems, economists compare and contrast the ways in which societies use their limited resources to meet unlimited wants.

TIPS FOR COMPARING AND CONTRASTING
Look for subjects that can be compared and contrasted.

Economic Systems

An economic system is the way in which a society uses its resources to satisfy its people’s needs and wants. Two common economic systems are the market system and the command system. Both systems provide answers to three basic economic questions: What to produce? How to produce? For whom to produce?

In a command economy, government economic planners decide what goods and services will be produced, how they will be produced, and for whom they will be produced. Individuals, then, have little or no influence on how economic decisions are made. In contrast, in a market economy the individual plays the major role in answering the basic economic questions. Consumers spend their money on the goods and services that satisfy them the most. In response, producers supply the goods and services that consumers want.

Few, if any, “pure” economic systems exist today. Most economic systems are “mixed.” For example, market economies generally have some limited form of government control—a characteristic of command economies. Most command economic systems are likewise mixed in that they have some elements of market economies.

**THINKING ECONOMICALLY** Comparing and Contrasting

1. How are market and command economic systems similar?
2. In what ways do these two economic systems differ?
3. Read the paragraphs about North Korea under the heading “Command Economies Today” on page 45. Construct a Venn diagram showing similarities and differences between the economy of North Korea and a typical market economy.
1. Explain the relationship between the terms in each of these pairs.
   a. private property rights
      market
   b. laissez-faire
      capitalism
   c. specialization
      profit
   d. factor market
      product market

2. What are the essential elements of market economies?

3. What are some advantages of market economies?

4. What are some disadvantages of market economies?

5. How does the profit motive help lead to efficient use of productive resources?

6. Using Your Notes Make charts for a traditional economy and a command
economy and compare and contrast them with your completed market economy chart.
   Use the Graphic Organizer at Interactive Review @ ClassZone.com

7. Analyzing Cause and Effect Review the circular flow model on page 53. Based on the model, how do businesses benefit from
   the wages they pay?

8. Creating and Interpreting Economic Models Return to the
   answer you gave for Application B on page 53. Create a circular
   flow model to illustrate your answer.

9. Solving Economic Problems How do you think the
disadvantages of a market economy can be minimized while its
advantages continue to operate?

10. Challenge On August 29, 2005, Hurricane Katrina devastated
    regions of the Gulf Coast states of Louisiana, Mississippi, and
    Alabama. Most of New Orleans, for example, was flooded after
    the levees protecting the city broke. How would a pure market
    economy respond to the devastation and loss?

   **CRITICAL THINKING**

   **Understanding the Market Economy** Market economies can be identified
   by certain fundamental characteristics. These include self-interested behavior,
   private property rights, voluntary exchange, profit, competition,
   consumer sovereignty, specialization, and a limited role for government.

   **Identify Features** Each sentence in the chart illustrates one fundamental feature
   of a market economy. Complete the chart by identifying these features.

   **Feature** | **Description**
   -------------|------------------
   An author secures a copyright for her latest novel.
   Declining sales signal the end of production for a model of car.
   A prospective employee and a business reach an agreement on salary and
   benefits.
   Taking advantage of their beautiful natural environment, local planners
   approve development of new hotels and resorts.

   **Challenge** Write sentences illustrating two fundamental features of market
economies not illustrated in the sentences above.