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# Free Enterprise at Work:

The Circular Flow Model

The American free enterprise (capitalist) system is a wonder of wonders. Just how do we ensure that all of our citizens needs are provided for? How do we make sure that we produce what we need and that those goods are allocated fairly (distribution). Of course I am referring to the three basic economic questions. So, just how do we ensure they are being answered properly? Well, the reality is, we don't!

In America and in all basically capitalist systems we rely on a rather complex theoretical model to tell us this whole free enterprise thing works. This model is called the ***Circular Flow Model***. What the circular flow model tells us is that three basic elements of the economy will work and interact together to ensure that our needs and wants are provided for.

There are three basic elements, or what are referred to as ***sectors,*** of the economy that must interact. These sectors are:

- Consumer
- Business
- Government

Circular flow basically shows us that input from each sector and to each sector spurs on production and thus goods and services are created. Here is a graphical representation of circular flow:

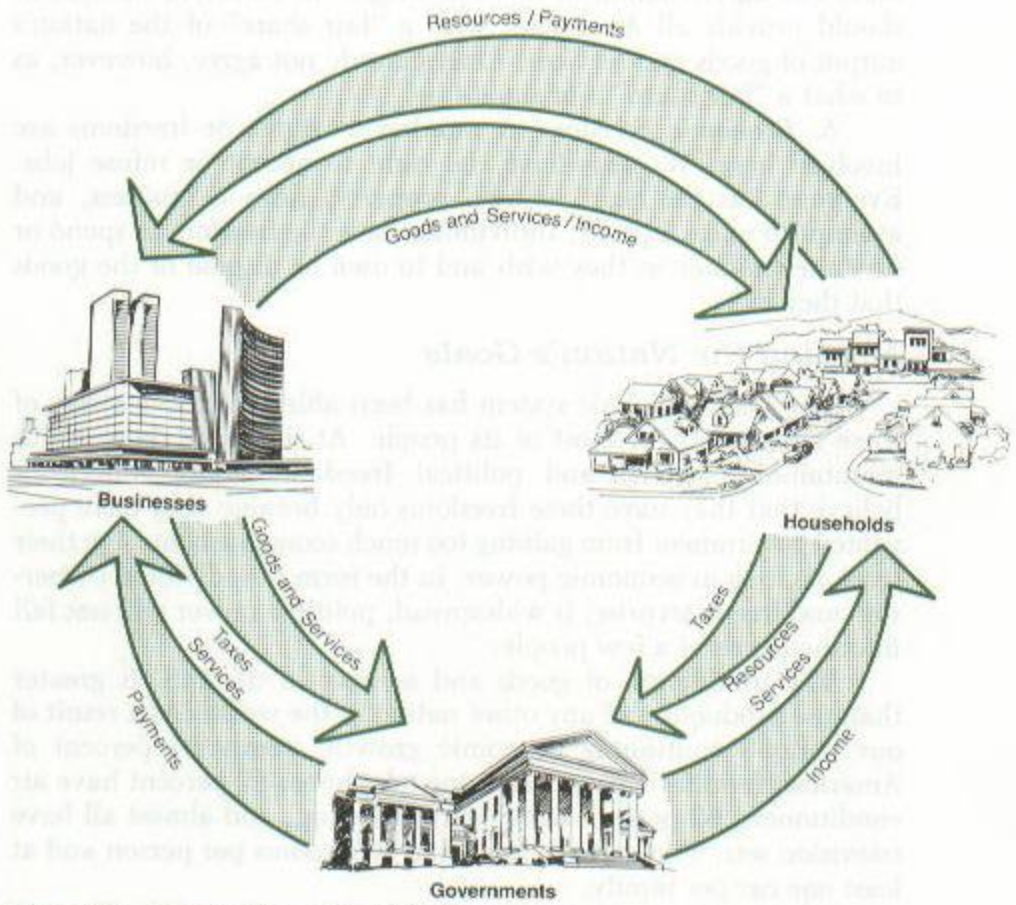


Figure 3.5 Circular Flow of the U.S. Economy

As you can see, each sector of the economy feeds another. Households (consumers) provide businesses with payments in exchange for jobs and goods and services. Government provides consumers and businesses with payments in exchange for goods and services from business and taxes and resources from consumers. It is what is called a symbiotic relationship. We all rely upon one another.

Is the circular flow model complete? No, nor is it meant to be. It is merely a theory that explains how free enterprise works. Banks for example, a very important part of the economy, are left out.

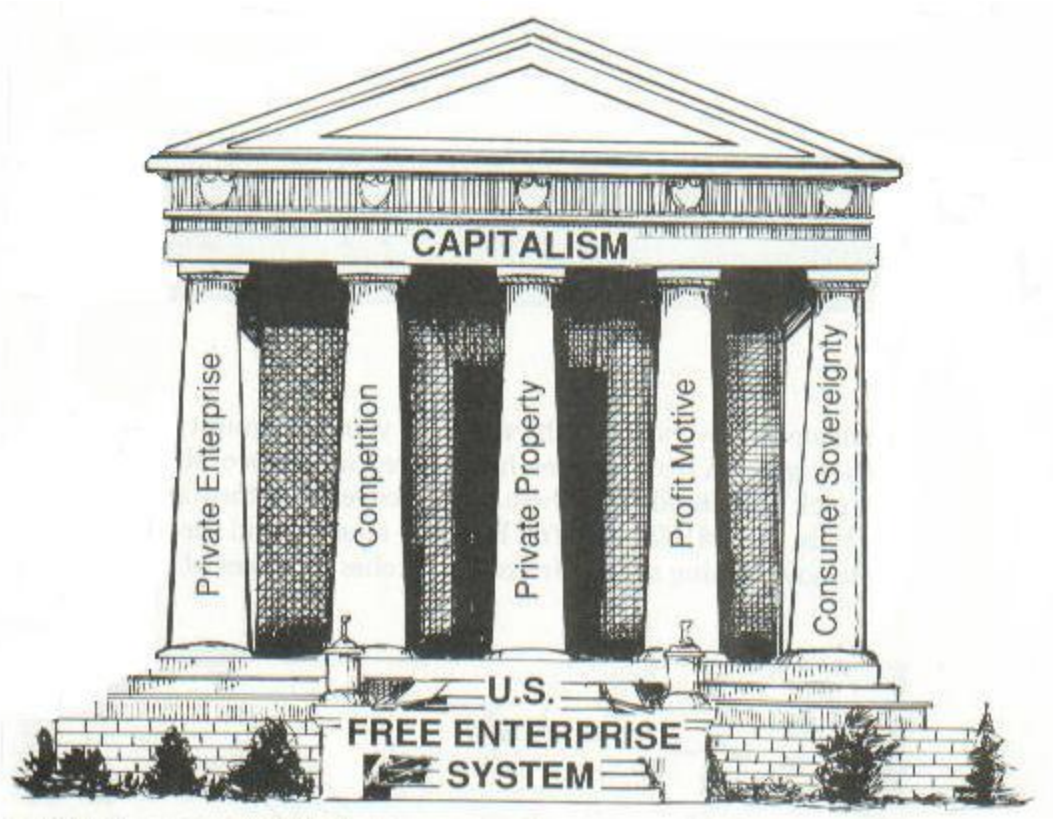
Some societies do not accept the circular flow model theory. These societies, therefore, choose another economic system other than capitalism. Socialists and communists see the role of the government in a different light than capitalists do. They see a government that must in some cases should provide for all needs (command) and in other cases provide for some needs (socialist). They do not trust that this will all just work out the way the theory says it will.

Does circular flow work? The answer is yes and no. Yes, in that we are a wealthy, productive society. No, in that there are some citizens who fall through the cracks and do not have their

needs met. We try to help them and thus move closer to socialism and increase the role of government. This is why we are really a mixed economy and not a pure capitalist economy.

# HOW DOES THE U.S. FREE ENTERPRISE SYSTEM OPERATE?

The U.S. economic system of free enterprise operates according to five main principles: the freedom to choose our businesses, the right to private property, the profit motive, competition, and consumer sovereignty.




*Freedom to Choose Our Businesses*

In this country, the decision whether or not you should go into computer or any other kind of enterprise (business) is basically yours alone to make. You will decide what fees to charge and what hours to work. Certain laws prohibit you from cheating or harming your customers or other people. But, in general, you will be left alone to run your business as you see fit.

*Right to Private Property*

Private property is a piece of land, a home, or a car owned by an individual, a family, or a group. It differs from a public building, or public property, such as the city hall, a park, or a highway, all of which provide a government service for all citizens. In the U.S. economic system, people's right to buy and sell private property is guaranteed by law. People must use the property in safe and reasonable ways, of course. In setting up computer systems for your customers, for example, you do not have the right to interfere with the electrical, telephone, or computer systems of other people.

*Profit Motive*

The main reason why you or any enterprising person organizes a business is to make money. You do this by earning more money than you spend. The amount of money left over after subtracting your business expenses from your business income is known as your profit. In the free enterprise system, business firms try hard to keep costs down and increase their income from sales. The better they succeed at this, the higher are their profits. Economists describe the efforts by business firms to earn the greatest profits as the profit motive.

*Competition*

Just as you are free to start a computer business, so is everyone else. The rivalry between sellers in the same field for consumers' dollars is called competition. If your business is profitable, it is likely that others will enter the same business hoping to be as successful as you are. They will be competing with you for the same customers. To win a share of the computer business, other sellers may try to offer more and better services, or services at lower prices. Because of the pressure of competition, business firms must constantly try to provide the best services and create the best products at the lowest possible prices.

*Consumer Sovereignty*

In the end, it is the customers, or consumers, who determine whether any business succeeds or fails. In the U.S. free enterprise economy, consumers are said to have sovereignty-the power or freedom to have final say. Consumers are free to spend their money for Product X or for Product Y. If they prefer Y over X, then the company making X may lose money, go out of business, or decide to manufacture something else (perhaps Product Z). Thus, how consumers choose to spend their dollars causes business firms of all kinds to produce certain goods and services and not others.

# Supply and Demand

Understanding the laws of supply and demand is central to understanding how the capitalist economy operates. Since we rely on market forces instead of government forces to distribute goods and services there must be some method for determining who gets the products that are produced. This is where supply and demand comes in. By themselves the laws of supply and

demand give us basic information, but when combined together they are the key to distribution in the market economy... price.

*What is demand?*

Demand is comprised of three things.

- Desire
- Ability to pay
- Willingness to pay

It is not enough to merely want or desire an item. One must show the ability to pay and then the willingness to pay. If all three conditions are not me then the demand is not real. This, by the way, is the purpose of advertising. While many may want a product it is quite another to be willing to pay. Advertising attempts to move a consumer from mere want to action. These day even condition two may not stand in the way of a consumer. With the advent of credit cards we are able to purchase products without the current ability to pay. Many stores and car dealers even offer on the spot credit though the interest rate may be quite high.

What factors alter your desire, willingness and ability to pay for products? Some factors include consumer income; consumer tastes the prices of related products like substitutes for that product of items that may complement that product.

*Marginal utility* - extra satisfaction a consumer gets by purchasing one more unit of a product.

*Diminishing Marginal Utility*: The more units one buys the less eager one is to buy more. Think of diminishing marginal utility this way. It is a hot summer day and your sweating bullets. You come across a lemonade stand and gulp down a glass. It tasted great so you want another. This second glass is marginal utility. But now you reach for a third glass. Suddenly your stomach is bloated and you're feeling sick. That's diminishing marginal utility!

There are two types of changes in demand:

*Changes in demand* - change in the demand for a product that occurs when price drops.

*Changes in the Quantity Demanded* - change in the amount of a product demanded regardless of price.

The difference is subtle but important. If the demand of ice cream goes up in the summer it is because consumers demand has truly increased, clearly it is hot. In the case the business can most likely raise prices without suffering a drop in sales. This is a change in quantity demanded. If sales of ice cream were to increase in January as a result of a price cut, however, the information we would be receiving is that the demand was artificially manipulated. It really tells us that actual demand is low and that extra efforts had to be made to increase sales. This is change in demand.

When there is a change in amount purchased (tied to demand) due to lower prices and surplus spending money it is called the *income effect*. Income effect basically happens when salaries are on the rise.

Another economic phenomenon tied to demand is *Substitution Effect*. This states that as prices drop consumers will buy more than usual at the expense of a different product. Take a sale at the mall for example. If jeans are on sale for a great price consumers will by extra jeans even if they had previously planned to buy something else. This is that great deal you just cannot pass up. What would the opportunity cost be? That item you passed up and substituted for.

**The Law of Demand*:***

*quantity demanded in inversely proportional to price.*

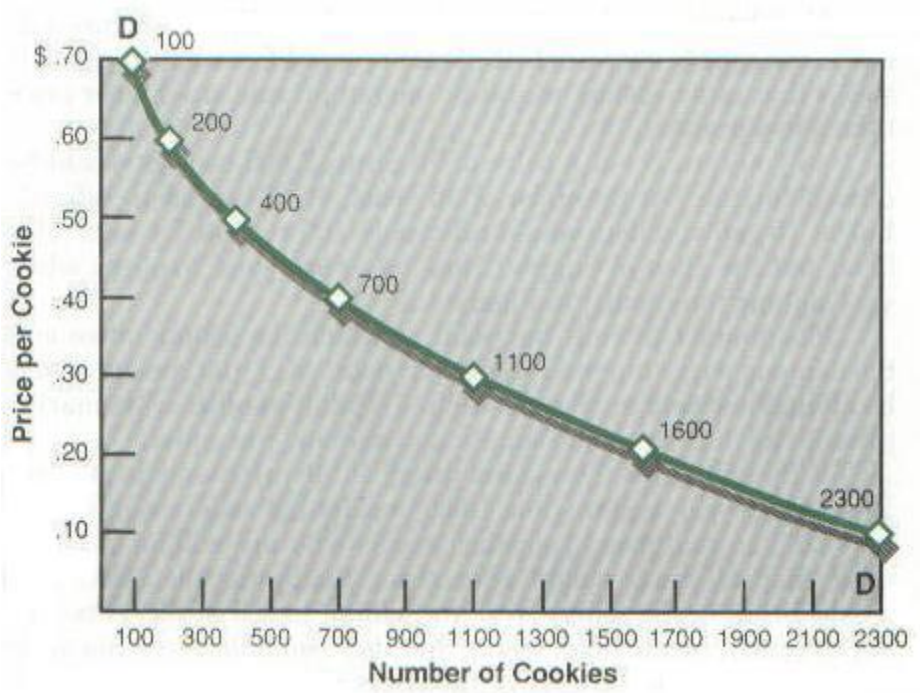
Simply put, the higher the price, the lower the demand and the lower the price, the higher the demand.

In numbers it would look like so:

**Demand Schedule for Cookies**

| At a price of | Consumer will buy |
|---|---|
| .70 cents | 100 cookies |
| .60 | 200 |
| .50 | 400 |
| .40 | 700 |
| .30 | 1,100 |
| .20 | 1,600 |
| .10 | 2,300 |

Economists also like to look at things graphically. It enables us to see the quantity and price on a limitless scale. To do this we plot what is known as a *demand curve.* The price is always on the vertical axis and the quantity is always on the horizontal axis. If we were to plot our points and draw a demand curve for the cookies it would look like this:




***The Law of Supply-***

*Quantity supplied is directly proportional to price.*

Clearly the law of supply is the opposite of the law of demand. Don't these both make sense to you? Consumers want to pay as little as they can. They will buy more as the price drops. Sellers, on the other hand, want to be able to charge as much as they can. They will be willing to make more and sell more as the price goes up. This way they can maximize profits.

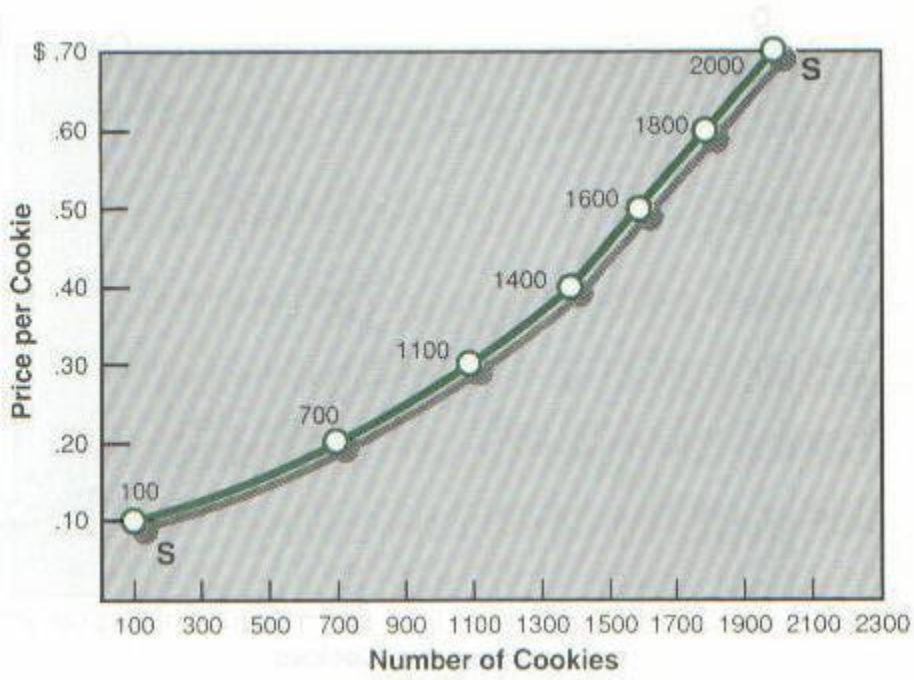
Numerically a supply schedule would look like this:

**Supply Schedule for Cookies**

| At a price of | Sellers will offer |
|---|---|
| .70 cents | 2,000 cookies |
| .60 | 1,800 |
| .50 | 1,600 |
| .40 | 1,400 |
| .30 | 1,100 |

| | |
|---|---|
| .20 | 700 |
| .10 | 100 |

The accompanying supply curve would be drawn like so:




**Market or Equilibrium Price**

Now that we have covered both demand and supply we have to combine both together. The place where what sellers are willing to sell for and buyers are willing to buy for is called *market* or *equilibrium pric*e. This is the price the product will sell for. *Price is negotiation between the buyers and the sellers.*

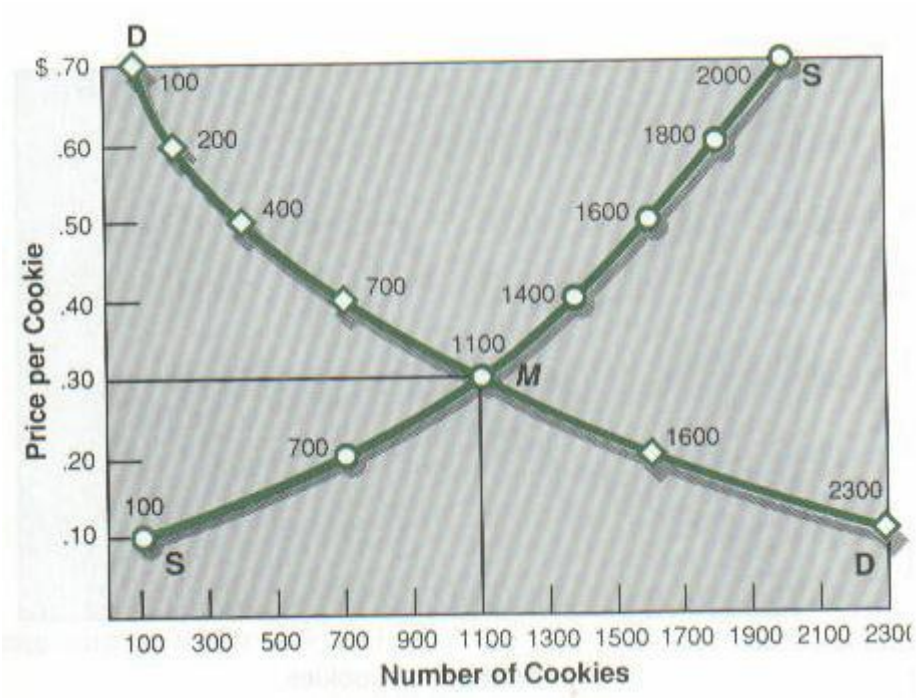
To figure out price one has to law the supply and demand next to each other.

**Supply and Demand of Chocolate Chip Cookies**

| Students will buy | At a price of | Sellers will offer |
|---|---|---|
| 100 | .70 cents | 2,000 |
| 200 | .60 | 1,800 |

| | | |
|---|---|---|
| 400 | .50 | 1,600 |
| 700 | .40 | 1,400 |
| 1,100 | .30 | 1,100 |
| 1.600 | .20 | 700 |
| 2,300 | .10 | 100 |

When we then plot and draw both curves together we are able to see the market price of the product.




**The market price for cookies in this graph is 30 cents. The quantity sold and bought is 1100 cookies.**

## WHY PRICES ARE IMPORTANT IN A MARKET ECONOMY

Prices are key ingredients in our economy because they make things happen. If buyers want to own some items badly enough, they will pay more for them. When sellers want to sell some items badly enough, they will lower their prices. Prices play such an important role in economic life that the United States is often described as a price-directed market economy. Let us see why.

1. *Act as Signals to Buyers and Sellers*. One of the things that prices do is carry information to buyers and sellers. When prices are low enough, they send a "buy" signal to buyers (consumers), who can now afford the things they want. When prices are high enough, they send a "sell" signal to sellers (retailers), who can now earn a profit at the new price.

2. *Encourage Efficient Production*. Prices encourage business people to produce their goods at the lowest possible cost. The less it costs to produce an item, the more likely it is that its producers will earn a profit.

Firms that are efficient will produce more goods with fewer raw materials than firms that are inefficient. Producers strive for efficiency as a way of increasing their profits. While these efforts are in the best interests of the sellers, all of us may benefit because we are provided with the things we want at lower costs.

3. *Determine Who Will Receive the Things Produced*. Finally, prices help to determine who will receive the economy's output of goods and services. The price that a worker receives for doing a job is called a wage. The amount of this wage determines how much the worker has to spend. What the worker can buy with those wages will depend, in turn, upon the prices of the goods and services the worker would like to own.

# ELASTICITY

Since the laws of supply and demand set price, prices are always subject to change based upon market forces and the interaction between the consumer and business. This change in prices and the degree of said change is known as *elasticity*.

There are two types of elasticity that we need to be concerned with. They are demand elasticity and supply elasticity.

***Demand Elasticity*** - the degree to which changes in price effect changes in demand. Demand is elastic when a small change in price effects a large change in demand. Such products that show great variability in demand are known to have *elastic demand.*

Demand is inelastic when a change in price does not bring about a correspondingly large change in demand, or any change at all. Said products are known to show inelastic demand.

How can we tell if an item is will be elastic or inelastic? The elasticity of demand can usually be estimated by examining the answers to three key questions. All three answers do not have to be the same in order to determine elasticity, and in some cases the answer to a single question is so important that it alone might dominate the answers of the other two. Let's examine the three questions.

*1. Can the purchase be delayed?*

The ability to delay or postpone the purchase of a product is one of the determinants of elasticity. If the purchase can be delayed, the demand for the product tends to be elastic. If it cannot be delayed it tends to be inelastic.

For example, since I can wait to buy a new stereo until the price drops demand will vary greatly in accordance with price. This product thus would tend to be elastic. Gasoline, on the other hand, I cannot wait for. Thus demand does not vary greatly with price and the product tends to be inelastic.

*2. Are adequate substitutes available?*

If a product has many substitutes, the demand for it tends to be elastic. The fewer substitutes available for a product, the more inelastic the demand. Note we are talking about **product** not brand!

For example, if the price of coffee were to go up dramatically then many people would switch to tea, thus a substitute is available. Since this is the case the price is causing demand to drop. This product would then be considered elastic. Since there is no real substitute for gasoline of heating oil, demand remains the same regardless of price. These products are inelastic.

*3. Does the purchase use a large portion of income?*

If a product is expensive, and is a large percentage of one's income, then the product tends to be more elastic. If a product is not a significant portion of the income the product tends to be more inelastic.

Take a house for example, if prices were to drop, demand would go up a lot. The same holds true for a car. A bar of soap, steak, clothes, since even an expensive product can be readily afforded the change in price is not a tremendous factor in demand.

**Elasticity of Supply -** When supply goes up price goes down and when price goes up supply goes down. Products are elastic if price has a large impact on supply; they are inelastic if supply remains relatively constant due to fluctuations in price.

Factors which effect supply elasticity are: Price, resource costs, technology, competitive products, profit expectations, number of sellers, natural events, taxes, subsidies and government regulations, overproduction, flooding the market, inability to produce an item, scarcity of natural resources.

# Advantages

## Free Enterprise

- Free enterprise and private ownership--two essential characteristics of a free-market economy--remain part of a mixed economic system. Under such a system, individuals are free to own property and operate for-profit businesses. The specific level and extent of free enterprise varies across countries. Some nations, such as the United States, emphasize free enterprise and private ownership of industry, while other countries' systems involve state ownership of some industries, such as transportation, energy and utilities. In addition, privately owned industries may be subject to a variety of government regulations.

## Social Safety Net

- One of the primary benefits of a mixed economy is the existence of a government-funded social safety net, which exists to provide at least a minimal level of subsistence for citizens. Sometimes referred to as a "welfare state," the benefits under this safety net include, but are not limited to, a publicly funded healthcare system for all citizens or at least some segments of the population, minimum wage laws, unemployment insurance and a publicly funded pension system. A pure market system with private ownership of industry and only minimal state intervention in the economy would, in theory at least, leave such social benefits to private charities. The United States' mixed economic system includes the Social Security system, a federal minimum wage law and healthcare benefits for the elderly under Medicare. Other nations, such as Canada, have universal healthcare systems.
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## Ability to Intervene

- The mixed economic system is based on the idea that government can improve economic outcomes through fiscal or monetary policy action. A mixed system gives government the flexibility to intervene in the economy in times of emergency. The best example of this was in 2008, when a global financial crisis threatened to plunge the economy into a global depression. The United States and other nations moved to stabilize their financial systems. The U.S. government, for its part, provided more than $700 billion in "bailout" funds to enable the nation's banks to clear toxic assets, backed by troubled mortgages, from their books.

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