2
The Market Economy: Pure and Simple

Key Terms

Market
Demand (and Demand Schedule)
Law of Demand
Utility
Diminishing Marginal Utility
Reservation Price
Income Effect
Substitution Effect
Supply (and Supply Schedule)
Law of Supply
Equilibrium
Changes in Demand
Changes in Supply
Determinants of Demand
Determinants of Supply
Price Elasticity
Pricetaker
Pricemaker
Market Imperfections
Economies of Scale
Market Failures
Public Goods
Externalities (or Spillovers)

Chapter Summary

1. The buying and selling of commodities is the beginning point of the economist's study of human behavior and institutions. These activities certainly predate capitalism but with the rise of capitalist, free-market philosophy after Adam Smith's *Wealth of Nations* (1776), the rules for and the workings of the market were systematically articulated.

2. Central to the working of a market economy is the free interaction of the forces of demand and supply in determining the price and output of specific goods. The demand schedule for a commodity ordinarily reflects the buyers' willingness to purchase more at lower prices and less at higher prices (an inverse relationship between price and quantity demanded). The supply schedule for a particular product reflects the sellers' willingness to produce and sell more goods at higher prices and less at lower prices (a direct relationship between price and quantity supplied). The interplay of the forces of demand and supply will eventually establish in the market an equilibrium price and equilibrium level of output at which neither a shortage nor a surplus of goods exists. The demand schedule, the supply schedule, and equilibrium may be illustrated and analyzed graphically.

3. The market is always a dynamic and changing mechanism. A variety of forces are ever at work determining the demand and supply schedules of any particular good. Changes in these determinants may produce changes (increases or decreases) in demand or supply or both which will, in turn, produce new equilibrium levels of price and quantity.

4. While, in theory at least, a market driven economy will work through the forces of competition to provide the goods consumers want, to keep prices and costs as low as possible, to encourage efficiency, to distribute income and output according to resource sellers' contributions and to encourage economic growth, market economies do suffer "real world" shortcomings: market imperfections and market failures. Excessive *monopoly power, inadequate knowledge* of products and prices, the failure to produce needed *public goods,* the failure to calculate *externalities* and the use of *common property resources* as well as the inability of the market to deal with problems of *dynamic instability* and certain *ethical and political objectives* of the society frequently require the larger society to intervene in markets to produce certain socially desired objectives. Thus, government interference in markets, although opposed in market theory, is a fact of life in the real world operation of markets.

Discussion and Essay Questions

1. List and explain the fundamental assumptions about individual and business behaviors that are central to the economic analyses set out by Adam Smith and other defenders of Classical Economics Ideology.

2. Consider the various factors that determine the demand for and supply of "normal good" X. How would the price and equilibrium output of that good be affected by the following developments (be sure to explain the reasoning you have used):
   a. The economy seems to be entering an inflationary period.
   b. Consumer incomes are rising.
   c. Labor productivity is increasing.
   d. The price of substitute goods is falling.

3. Explain the underlying economic logic of why demand curves are drawn downward sloping to the right while supply curves are represented as upward sloping to the right.

4. In what sense can it be argued that a market economy has "a natural tendency" toward equilibrium?

5. Explain the concept of "elasticity of demand." Of the following items, which would you expect to have a more elastic demand and which a more inelastic demand? Why?
   - Salt
   - Sugar
   - New Ford Focuses
   - Restaurant meals
   - Cigarettes
   - Shoes
   - On-demand movies
   - Mobile phones

6. Summarize the logic of those who argue that a market economy will provide better results than those obtained through efforts at intervention in the working of the market.

7. Discuss some of the "real world" difficulties with markets that indicate that in actual practice conditions arise which do not always produce the "ideal" outcomes of pure market model.

8. Distinguish between and give examples of market imperfections and market failures.

Test Bank Questions

True-False Questions

F 1. Markets can be expected to automatically compensate for problems of external costs or external benefits.

F 2. Adam Smith believed that the existence of competition and self-interest might get out of hand in a free market and therefore advocated the use of "the invisible fist" of government to control market economies.

T 3. Although opposed to government intervention in the working of markets, defenders of free market economic theory still believe that government has an important place in a market society in protecting private property rights and enforcing "the rules of the game" in market transactions.

T 4. According to the law of demand we would expect that if the price of a good rises, the consumer will choose, *ceteris paribus*, to buy fewer units of the good.

F 5. The substitution effect is explained by the fact that at lower levels of prices we have more income to buy goods.

F 6. The law of supply holds that price and quantity supplied are inversely related.

T 7. The supply curve slopes upward to the right because, at least in the short run, efforts to raise output involve rising per unit production costs.

T 8. Assume a free market where a surplus currently exists. Left to itself, we would expect the market to adjust by seeing prices fall and quantity supplied decline.

T 9. Changes in demand may be accounted for by changes in a number of nonprice determinants of demand (such as consumer tastes, number of consumers, expectations, etc.), but changes in quantity demanded are only the result of price changes.

F 10. Inferior goods differ from normal goods in that as our income rises we are more likely to increase inferior goods consumption and lower normal goods consumption.

F 11. Ordinarily, the expectation that prices will fall in the future should spur current consumer spending.

T 12. A leftward shift in the supply curve of product A indicates a decrease in supply such as we might expect from the rise in resource prices used in the production of product A.

T 13. If we know that both the demand and supply of product X has increased, we can be certain that equilibrium output will increase but we do not know if price increases or decreases.

T 14. Those goods whose demand tends to be more inelastic over a given price range are probably goods for which there are few substitutes.

T 15. The principal determinant of the elasticity of supply of a particular good is time.

F 16. In the long run the supply of any particular product tends to be increasingly inelastic.

F 17. The reservation price in economics refers to the price of cigarettes at Onondaga Nation Territory stores.

F 18. Appropriate government policy for dealing with externalities would be to substitute those goods with external costs and to tax those goods with high external benefits.

F 19. A good way to raise revenue is to raise the price of goods that have elastic demand.

F 20. Market imperfections tend to improve the efficiency of markets.

Multiple Choice

C 1. Adam Smith maintained that all of the following were essential to a market

economic system except:
a. private property
b. freedom of choice
c. a large and powerful national government
d. the exercise of rational, maximizing behavior by all market participants
e. competition

D 2. The law of demand holds that:
a. prices and quantity demanded are directly related
b. price and quantity demanded have no relationship
c. the demand curve is upward sloping to the right
d. quantity demanded will rise if price falls
e. none of the above

D 3. Equilibrium in a given product market is obtained:
a. when there are no shortages or surpluses of that product
b. when at a particular price $Q_D = Q_S$
c. at the point on the graph where demand and supply intersect
d. all of the above
e. none of the above

D 4. A government-imposed price above the equilibrium market price will produce
a. a shortage
b. a decline in demand
c. an increase in supply
d. a surplus
e. a new equilibrium price

D 5. Which of the following events could be expected to produce an increase, *ceteris paribus*, in the sales of college economics textbooks?
a. an increase in the number of economic textbook companies
b. a decrease in the price of textbook publication costs
c. an increase in economics majors
d. all of the above
e. none of the above

D 6. Tennis balls and tennis racquets are a good example of:
a. inferior goods
b. capital goods
c. substitute goods
d. complementary goods
e. none of the above

A 7. Holding supply constant and increasing demand for automobiles should, in a free market:
a. lead to a higher equilibrium price and a higher equilibrium output
b. lead to lower equilibrium price and a lower equilibrium output
c. lead to a lower equilibrium price and a higher equilibrium output

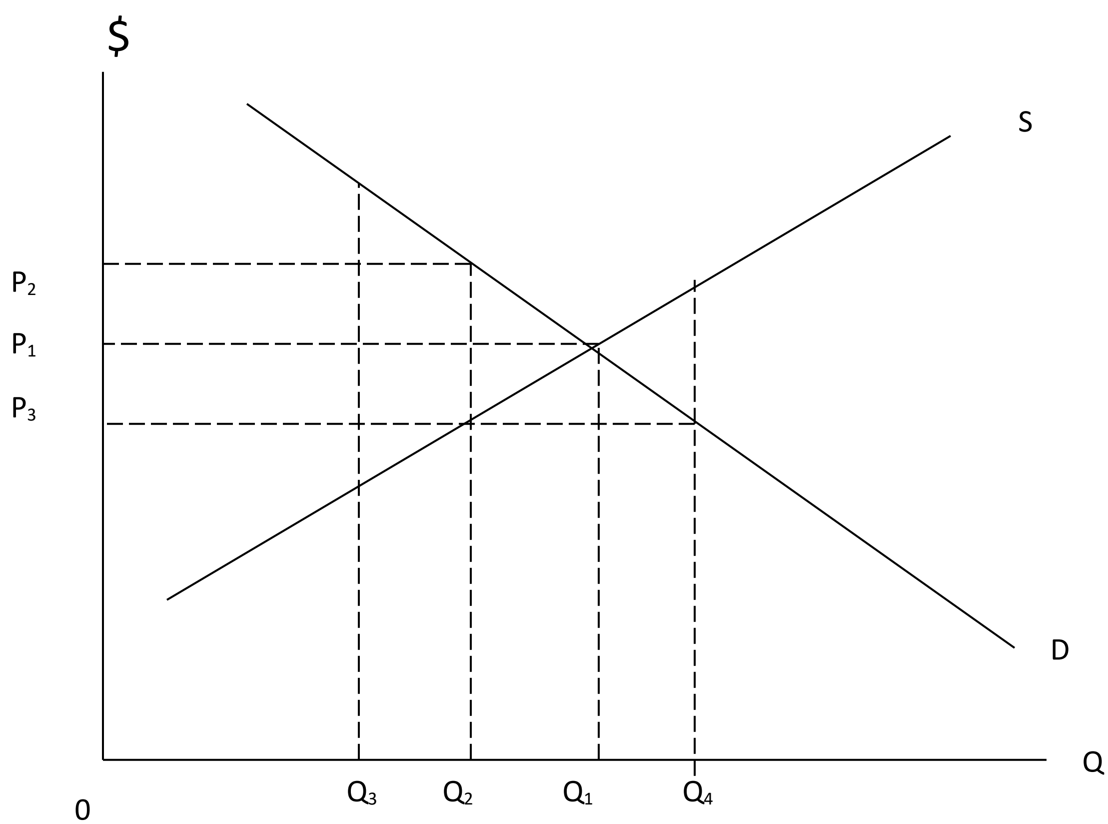
d. lead to a higher equilibrium price and a lower equilibrium output

A 8. The development of monopoly power that provides a seller with pricemaking power is an example of:
   a. a market imperfection
   b. a market failure
   c. dynamic instability
   d. an ethical contradiction
   e. none of the above

D 9. An example of a Common Property Resource is (are):
   a. The Great Lakes
   b. The Redwood Forest
   c. The electromagnetic spectrum used for communications
   d. all of the above
   e. none of the above

C 10. An example of an externality is:
   a. fire protection
   b. national defense
   c. industrial pollution
   d. monopoly power
   e. all of the above

Use the supply and demand curves in the following diagram to answer the next five questions.



C 11. The equilibrium price and quantity are:

a. P_2 and Q_2, respectively
b. P_1 and Q_2, respectively
c. P_1 and Q_1, respectively
d. P_3 and Q_4, respectively
e. none of the above

B 12. If price is initially P_1 and is reduced to P_3, then:

a. quantity supplied will rise to Q_4 and quantity demand will fall to Q_3
b. quantity supplied will fall to Q_3 and quantity demanded will increase to Q_4
c. supply will decrease and demand will increase
d. no prediction can be made about the effect of the price change

C 13. A ceiling price that causes a shortage is best represented by:

a. P_1
b. P_2
c. P_3
d. none of the above

D 14. Which of the following represents a surplus condition?

a. P_3 price
b. P_1 price
c. Q_2 output
d. P_2 price

B 15. In order for the equilibrium price to be P_2, which of the following events must occur?

a. supply increases
b. demand increases
c. price must fall
d. consumers must stop buying the product
e. a Democrat must be elected president

A 16. Which of the following statements is correct?

a. The market eliminates shortages through a price increase that increases the quantity supplied and decreases the quantity demanded.
b. The market eliminates surpluses by raising price and decreasing quantity supplied.
c. The market eliminates shortages through a price decrease that increases demand.
d. Individual choices concerning collective satisfaction are deliberated behind a wall of ignorance.

D 17. Which of the following is the correct formula for elasticity of demand?

a. $\dfrac{\text{\% change in price}}{\text{\% change in quantity}}$

b. <u>change in price</u>
change in quantity
c. <u>change in demand</u>
change in price
d. <u>% change in quantity demanded</u>
%change in price
e. none of the above

C 18. The law of supply states that the relationship between price and quantity supplied in a given time period is
a. negative
b. inverse
c. direct
d. indeterminate

D 19. Mr. McConnell observes that when his publisher raises the price of his textbook the publisher's revenue goes up and he receives a larger royalty check. He may safely conclude that:
a. the demand for the textbook is falling
b. the demand for the textbook is elastic
c. the demand for the textbook is unit elastic
d. the demand for the textbook is inelastic

A 20. Diminishing marginal utility means:
a. a consumer realizes less additional satisfaction as additional units are consumed
b. a consumer realizes more satisfaction as additional units are consumed
c. the product becomes less useful when bought in large quantities
d. a market equilibrium may be in doubt