

CHAPTER

3

Economic Institutions

Chapter Goals

- Define *market economy* and compare and contrast socialism with capitalism.
- Describe the role of businesses and households in a market economy.
- List and discuss the various roles of government.
- Explain why global policy issues differ from national policy issues.

Economic Systems

Markets are based on **institutions** defined as *“the formal and informal rules that constrain human economic behavior.”*

Institutions include:

- laws that protect property
- the legal system to enforce and develop laws
- political systems that develop the laws and
- cultural traits of society

Economic Systems

The U.S. economy is a **market economy**, which is an economic system based on private property and the markets in which, in principle, individuals decide how, what, and for whom to produce.

Markets work through a system of rewards and payments

Individuals are free to do whatever they want as long as it is legal

Fluctuations in prices play a central role in coordinating individuals' wants in a market economy

Capitalism and Socialism

Capitalism is an economic system based on the market in which the ownership of the means of production resides with a small group of individuals (called **capitalists**).

Socialism is an economic system based on individuals' goodwill towards others, not on their own self-interest, and in which, in principle, *society* decides what, how, and for whom to produce.

Socialism

In principle socialism is where all people contribute what they can and get what they need.

The problems regarding what, how, and for whom are answered in the best interest of the individuals in society.

China and Venezuela are often identified as socialistic in the news.

Socialism

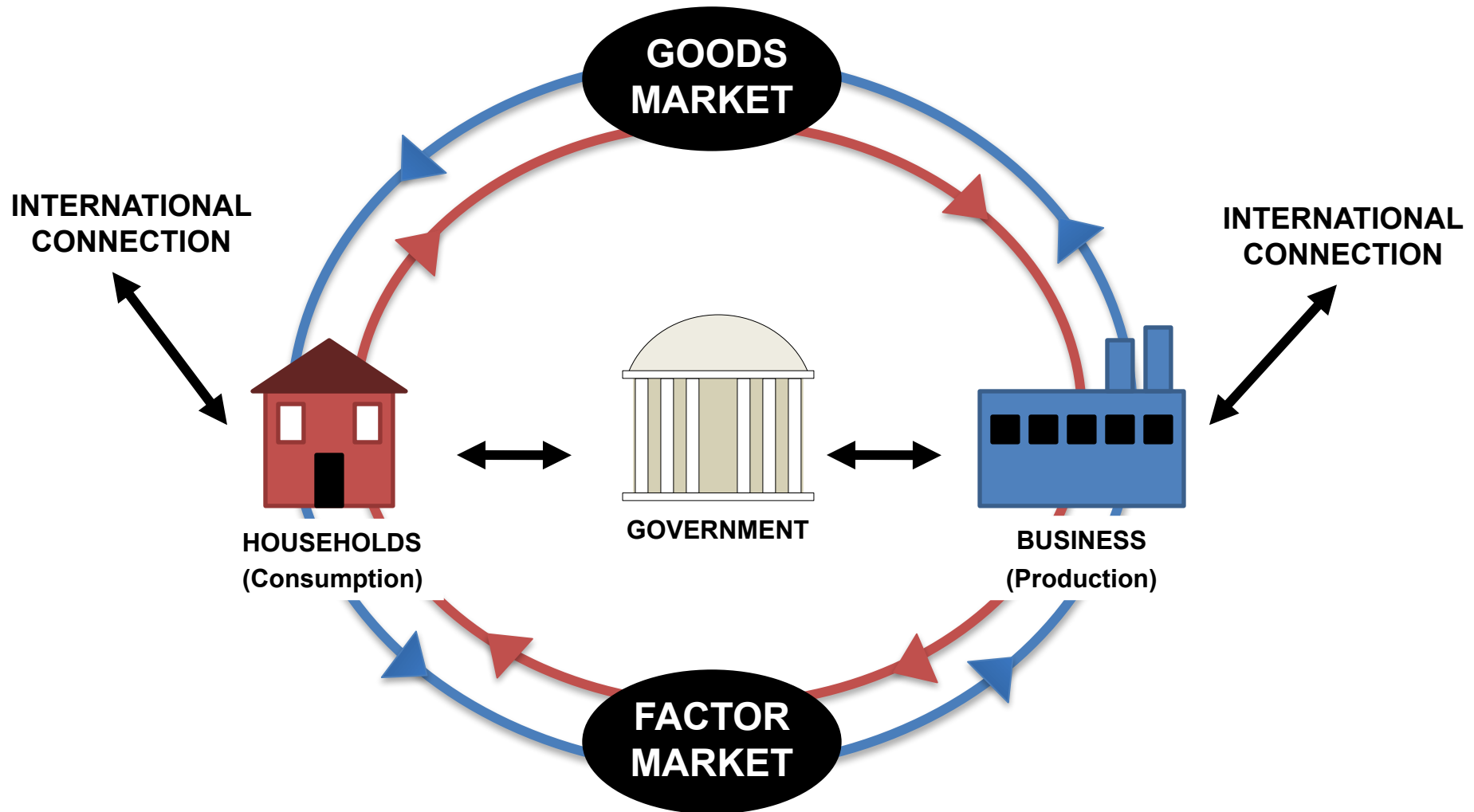
Based on government ownership of the means of production.

In a centrally planned socialist economy, government planning boards set society's goals and then directed individuals and firms as to how to achieve those goals.

Sometimes called a *command economy*.

People today talk little about differences in economic systems; **instead they talk about differences in institutions.**

Economic Institutions in a Market Economy



U.S. economy: Connections between households, businesses and government.

Business

Businesses are private producing units in our society.

Businesses in the United States decide *what* to produce, *how much* to produce, and *for whom* to produce it.

Businesses produce what they believe will sell and make a profit.

By channeling the desire to make a profit for the general good of society, the U.S. economic system allows the invisible hand to work.

Although businesses decide what to produce, they are guided by **consumer sovereignty**.

Forms of Business

Sole proprietorships: businesses that have only one owner

Partnerships: businesses with two or more owners

Corporations: businesses that are treated as a person, and are legally owned by their stockholders, who are not liable for the actions of the corporate “person”

Flexible-purpose Corporations, Benefit Corporations (B-corporations), L3C

Households

Households are groups of individuals living together making joint decisions.

Households supply the labor with which businesses produce and government governs.

In the economy, households vote with their dollars to determine what businesses produce.

Besides being suppliers of labor, households make a significant number of the decisions that impact the economy.

The Roles of Government

The government plays two general roles in the economy:

1. An actor who collects money in taxes and spends that money on projects, such as defense and education.
2. A referee who sets the rules that determine relations between businesses and households.

Government as an Actor

The United States has a federal government system, which means we have various levels of government (federal, state, and local) each with its own powers.

Together all levels of government consume about 18% of the country's total output and employ about 22 million individuals.

The state and local levels of government employ over 19 million people and spend about \$3 trillion a year.

Government as a Referee

Government sets the rules (laws) which regulate the interactions between households and businesses.

Some examples of laws:

- Businesses have to comply with equal opportunity and labor laws.
- Many working conditions are subject to government regulation, such as safety and overtime rules.
- Businesses cannot meet with other businesses to agree on prices they will charge.
- In some businesses, workers have to join a union to work at certain jobs.

Six Roles of a Government in a Market

In its role as both an actor and a referee, government plays a variety of specific roles in the economy.

These roles include:

1. Providing a stable set of institutions and rules
2. Promoting effective and workable competition
3. Correcting for externalities
4. Ensuring economic stability and growth
5. Providing public goods
6. Adjusting for undesirable market results

Market Failures and Government Failures

Market failures are situations in which the market does not lead to a desired result.

Government failures are situations in which the government intervenes and makes things worse.

Policymakers must decide which failure is the least problematic, a market or government failure.

Global Institutions and Corporations

The U.S. economy makes up about 15% of the world output and consumption, but only 6% of the world's land mass and just over 4% of the world's population.

U.S. economic institutions are integrated with the world's economy.

Global corporations are corporations with substantial operations in both production and sales in more than one country.

Global corporations create jobs, bring new technologies, and provide competition for domestic companies.

Coordinating Global Issues

There is no global government to regulate global corporations but governments have developed international institutions to promote negotiations and coordinate economic relations among countries.

Some examples of international institutions:

- The **United Nations** is an organization designed to achieve international cooperation but it has no ability to tax or enforce its policies on its members.
- The **World Bank** is a multinational, international financial institution that works to secure loans for developing countries.

Coordinating Global Issues

Additional examples of international institutions:

The **International Monetary Fund (IMF)** is a multinational, international financial institution concerned with monetary issues.

The **Group of Seven (G7)** meets to promote negotiations and coordinate economic relations among nations. These five countries include Japan, Germany, Britain, France, United States, Canada, and Italy.

The **North American Free Trade Act (NAFTA)** is an organization devoted to reducing trade barriers between the United States, Mexico, and Canada.

Chapter Summary (1 of 3)

The U.S. economy is a market economy (capitalistic) that gives property rights to individuals and relies on market forces to solve the *what, how, and for whom* problems.

Socialism in principle, solves the *what, how, and for whom* problems in the best interest of the individuals in society.

In practice, socialism is an economic system based on government ownership of the means of production with economic activity governed by central planning.

There are connections among businesses, households, and government in the U.S. market economy.

Chapter Summary (2 of 3)

Businesses decide *what, how much, and for whom* decisions in production.

Success or failure of businesses depends on their ability to meet consumers' desires. This is called *consumer sovereignty*.

The three main forms of businesses are proprietorships, partnerships, and corporations.

Households are the most powerful economic institution but have given much of their power to government and business.

Households supply labor and influence business decisions through consumer sovereignty.

Chapter Summary (3 of 3)

Government plays two general roles in the economy: (1) as a referee and, (2) as an actor.

The six roles for government include:

1. Providing a stable set of institutions and rules
2. Promoting effective and workable competition
3. Correcting for externalities
4. Ensuring economic stability and growth
5. Providing public goods
6. Adjusting for undesirable market results

Because there is no world government, governments enter voluntary organizations that regulate international markets.