



Decision Making in a Market Economy

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Overview

• Before we can look at these principles, we need to explain what we mean by the words,

• **Economy**

and

• **Economics**

Economy

- The word **economy** comes from a Greek word for “**one who manages a household.**”
- But what does a single household have to do with the national economy?

A household and an economy face many similar decisions

A household must decide...

- ◆ Who will work?
- ◆ What will it produce, or what kind of jobs will its members have?
- ◆ What resources will it use?
- ◆ Whom will it sell its products to, or
- ◆ Whom will its members work for?

An economy must decide...

- ◆ What to produce?
- ◆ How to produce?
- ◆ For whom to produce?

Different economic systems answer these questions differently

- Free enterprise (capitalistic) economies.
- Centrally planned (command) economies.
- Mixed economies.

Economics...

• is the study of how society manages its **scarce** resources.

• **Scarcity** means society has less to offer than people wish to have–

- **wants are unlimited but**
- **resources are limited.**

In economics we study...

- ◆ how people make decisions (*micro*)
- ◆ how people interact with each other (*micro and macro*)
- ◆ what forces affect the economy as a whole (*macro*)

The American Economy

- **Economics** – Sometimes called the “dismal science”
- **Morality** – is how we'd like things to be.
- **Economics** – is how are.

Factors of Production

- Land
- Labor
- Management
- Capital



Various Economic Systems over time:

- Barter Systems (trade w/o currency)
- Mercantile System (raw materials acquired by colonies – finished goods sold back to colonies.)
- Centrally Planned Economies
 - Communist / Socialists
- Capitalist or Free Market Systems

The 5 Pillars of Capitalism

- Private Enterprise
- Competition
- Private Property
- Profit motive
- Consumer sovereignty

Economics & Free Markets

In a Free Market Economy

- How do decisions get made?
 - Adam Smith 1776 *The Wealth of Nations*
 - The principle of the invisible hand
 - The importance of competition

The Amazing Invisible Hand

- Did you worry if there would be food on the table today?
- Are you worried there might not be gas at the gas station?
- Will there be enough screwdrivers in stock at the hardware store?

Who Does the Planning?

- Production and distribution of goods and services is determined by *the system itself*
- Adam Smith described this in *The WEALTH OF NATIONS* in 1776
- In order to maximize profits, businesses must produce the goods and services that consumers wish to buy.

The Importance of Competition

- Smith described an economy without corporations, patent laws, or other barriers
- No Labor Unions, Government Regulations or Brand Advertising
- The key to the invisible-hand idea is perfect competition

The Price System

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- We need signals to convey information to producers and consumers
 - Prices send these signals between
 - Buyers & Sellers
 - Employers & Employees

Functions of Government

- Making & Enforcing the Rules
- Protector
 - Private Property
 - Environmental Quality
 - Military
- Producing Collective Goods
 - Education
 - Public Health

The 5 Pillars of Capitalism



Functions of Government

Regulating Prices of natural monopolies:
Example: Water, Gas and Electric Utilities
Regulating Quality of Service
Example: FDA / Dept of Regulation & Licensing

The Basic Societal Questions:

What Shall be Produced?

How Shall Goods & Services Be Produced?

For Whom Shall Goods & Services Be Produced?

Potential vs. Actual Performance

- Barriers to Entry
- Cost of Substitutes
- Cost of Capital
- Population Growth
- Technology

Where doesn't the invisible-hand work?

- Drug industry (Patented Drugs)
- Military Defense?
- Environmental Stewardship?
- Public Education?

The Price System

- An economy must have a coordination and communications system through which various sectors can communicate
- Communicating between Buyers & Sellers
- Communicating between Employers & Employees

Government Intervention

- How much government involvement?
- Certain involvement is necessary..
 - Public Goods
 - Rule Maker / Referee
 - Sometimes Regulator of Prices...
 - Regulator of Standards?

Three BASIC Questions

- What Goods & Services Shall Be Produced
 - Consumer Sovereignty (People vote with their dollars)
- How Should they Be Produced?
 - Determined by production costs (Prices)
- For Whom Shall the Goods & Services Be Produced?
 - W/O Government, Strictly on the basis of \$\$
 - People with the most \$\$ aren't necessarily the most deserving

Potential vs Actual Performance

- What economic tools does the government use to “control” the economy?
 - Interest Rates
 - Money Supply
 - Deficit Spending
 - Business Regulations & Laws

The US Agriculture Industry

- ✓ Past – Production Oriented
- ✓ Present – Profit Oriented
- ✓ Future – Customer Oriented
 - ✓ Both Internal & External