

GLOBAL  
EDITION



# Essential Foundations of Economics

SEVENTH EDITION

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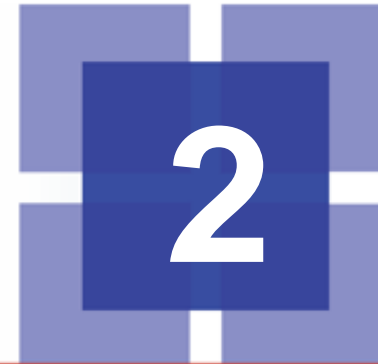
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PEARSON



**Who makes the Dreamliner?**

# The U.S. and Global Economies



## CHAPTER CHECKLIST

**When you have completed your study of this chapter, you will be able to**

- 1** Describe what, how, and for whom goods and services are produced in the United States.
- 2** Describe what, how, and for whom goods and services are produced in the global economy.
- 3** Use the circular flow model of the U.S. economy and of the global economy.

## 2.1 WHAT, HOW, AND FOR WHOM?

### ■ What Do We Produce?

We divide the vast array of goods and services produced into:

- Consumption goods and services
- Capital goods



## 2.1 WHAT, HOW, AND FOR WHOM?

**Consumption goods and services** are goods and services that are bought by individuals and used to provide personal enjoyment and contribute to a person's standard of living.

Examples are movies and laundromat services.

**Capital goods** are goods that are bought by businesses to increase their productive resources.

Examples are cranes and trucks.

## 2.1 WHAT, HOW, AND FOR WHOM?

### ■ How Do We Produce?

**Factors of production** are the productive resources used to produce goods and services.

Factors of production are grouped into four categories:

- Land
- Labor
- Capital
- Entrepreneurship

## 2.1 WHAT, HOW, AND FOR WHOM?

### Land

**Land** includes all the “gifts of nature” that we use to produce goods and services.

Land includes all the things we call natural resources.

Land includes minerals, water, air, wild plants, animals, birds, and fish as well as farmland and forests.

## 2.1 WHAT, HOW, AND FOR WHOM?

### Labor

**Labor** is the work time and work effort that people devote to producing goods and services.

The quality of labor depends on how skilled people are—what economists call human capital.

**Human capital** is the knowledge and skill that people obtain from education, on-the-job training, and work experience.



## 2.1 WHAT, HOW, AND FOR WHOM?

### Capital

**Capital** consists of tools, instruments, machines, buildings, and other items that have been produced in the past and that businesses now use to produce goods and services.

Capital includes semifinished goods, office buildings, and computers.

Capital does *not* include money, stocks, and bonds. They are financial resources.

## 2.1 WHAT, HOW, AND FOR WHOM?

### Entrepreneurship

**Entrepreneurship** is the human resource that organizes labor, land, and capital.

Entrepreneurs come up with new ideas about what and how to produce, make business decisions, and bear the risks that arise from these decisions.

## 2.1 WHAT, HOW, AND FOR WHOM?

### ■ For Whom Do We Produce?

Factors of production are paid incomes:

**Rent** Income paid for the use of land.

**Wages** Income paid for the services of labor.

**Interest** Income paid for the use of capital.

**Profit (or loss)** Income earned by an entrepreneur for running a business.

## 2.1 WHAT, HOW, AND FOR WHOM?

**Functional distribution of income** is the distribution of income among the factors of production.

**Personal distribution of income** is the distribution of income among households.

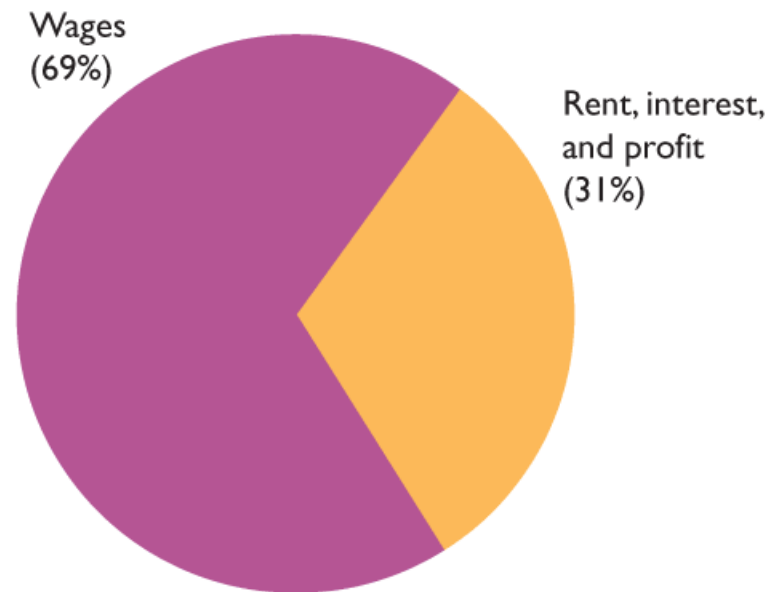
## 2.1 WHAT, HOW, AND FOR WHOM?



Figure 2.1(a) shows the functional distribution of income in 2011:

Wages 69%

Rent, interest, and profit 31%



**(a) Functional distribution of income**

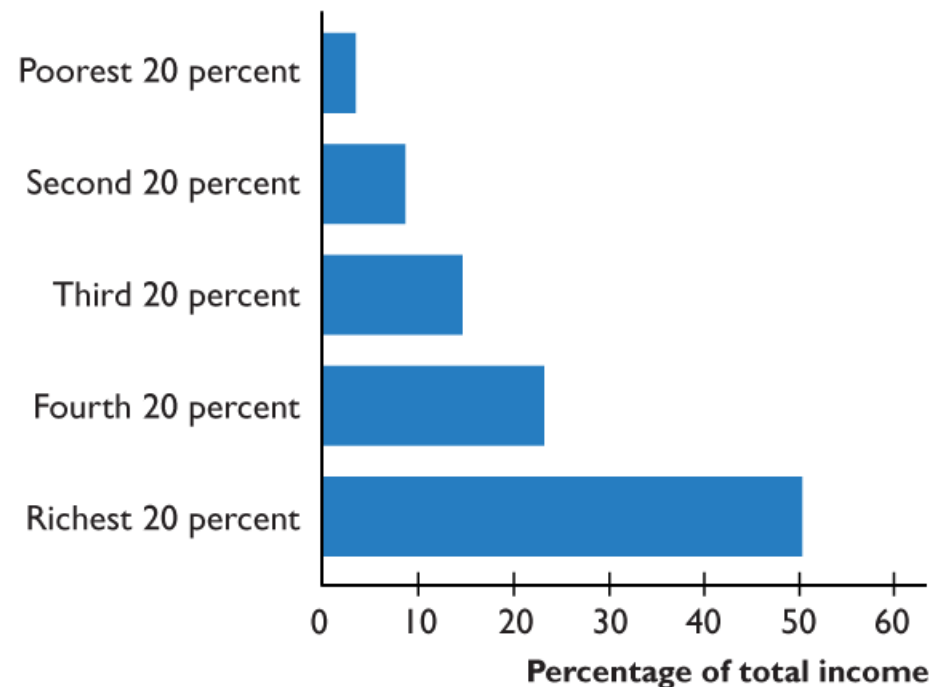
## 2.1 WHAT, HOW, AND FOR WHOM?



Figure 2.1(b) shows the personal distribution of income in 2011:

The poorest 20% earned only 3% of total income.

The richest 20% earned 50% of total income.



(b) Personal distribution of income

## 2.2 THE GLOBAL ECONOMY

### ■ The People

U.S. population: 315,824,000 ( May 9, 2013)

World population: 7, 084,065,000

The U.S. clock ticks along showing a population increase of one person every 12 seconds.

The world clock spins faster, adding 30 people in the same 12 seconds.



## 2.2 THE GLOBAL ECONOMY

### ■ The Economies

#### **Advanced Economies**

The richest 29 countries (or areas).

Almost 1 billion people (15 percent of the world's population) live in advanced economies.

## 2.2 THE GLOBAL ECONOMY

### **Emerging Market and Developing Economies**

Emerging market economies are the 28 countries of Central and Eastern Europe and Asia.

Almost 500 million people live in these countries.

Developing economies are the 119 countries in Africa, Asia, the Middle East, Europe, and Central and South America that have not yet achieved high average incomes for their people.

More than 5.5 billion people live in these countries.

## 2.2 THE GLOBAL ECONOMY

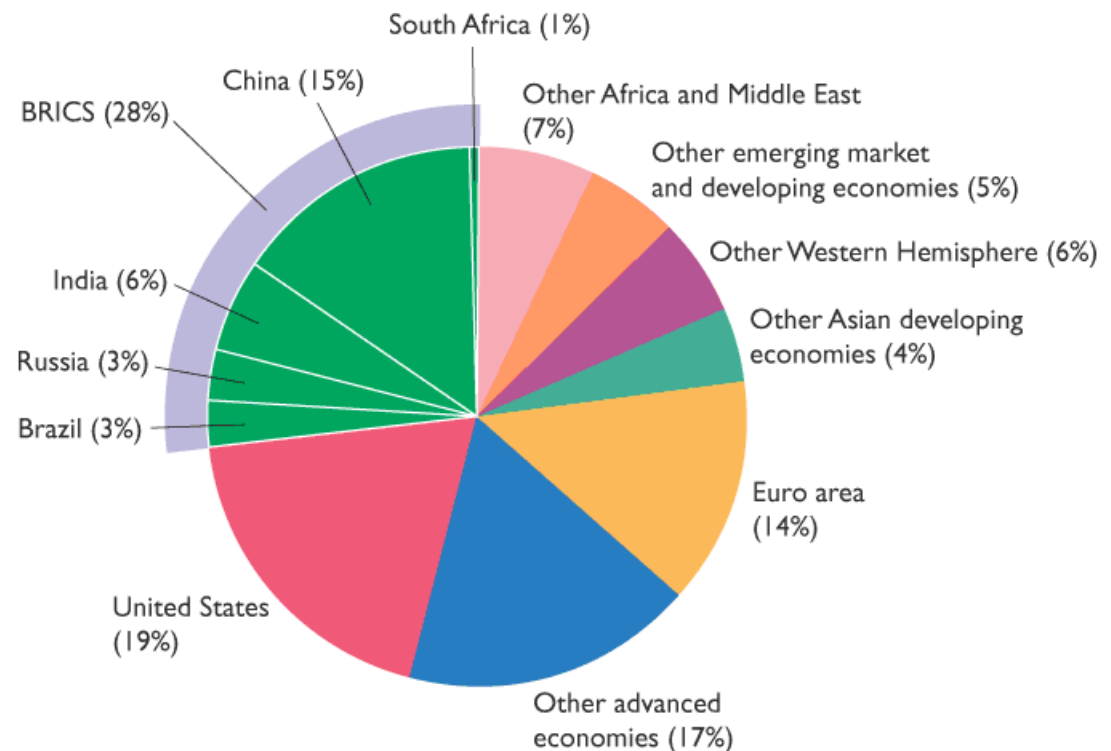


### ■ *What in the Global Economy?*

In 2013, global production was worth about \$87 trillion.

### Where Is the Global Pie Baked?

Figure 2.2 gives the answer.



## 2.2 THE GLOBAL ECONOMY

### Some Differences in What Is Produced

Developing economies have large and growing manufacturing industries, which produce textiles, footwear, sports gear, toys, electronic goods, furniture, steel, and even automobiles and airplanes.

Food production is a small part of the U.S. and other advanced economies and a large part of the developing economies such as Brazil, China, and India.

But the advanced economies produce about one third of the world's food.

## 2.2 THE GLOBAL ECONOMY

### Some Similarities in What Is Produced

Retail industries in advanced economies are similar, but so are the structure of *what* they produce.

Agriculture and manufacturing are smaller percentages of total production and are shrinking whereas services are a larger percentage and growing.

## 2.2 THE GLOBAL ECONOMY

### ■ *How in the Global Economy?*

#### **Human Capital Differences**

The quality of labor depends on human capital.

The differences in human capital between the advanced economies and the developing economies is enormous and it arises from:

- Education, on-the-job training, and experience
- Physical ability and state of health.

## 2.2 THE GLOBAL ECONOMY

### Physical Capital Differences

The physical capital available for producing goods and services differentiates an advanced economy from a developing economy:

- Transportation system—advanced economies are more developed.
- Technologies used on farms and in factories—advanced economies use more capital-intensive technologies.



## 2.2 THE GLOBAL ECONOMY

### ■ *For Whom* in the Global Economy?

Who gets the world's goods and services depends on the incomes that people earn.

Figure 2.3 (on the next slide) shows the distribution of incomes around the world.

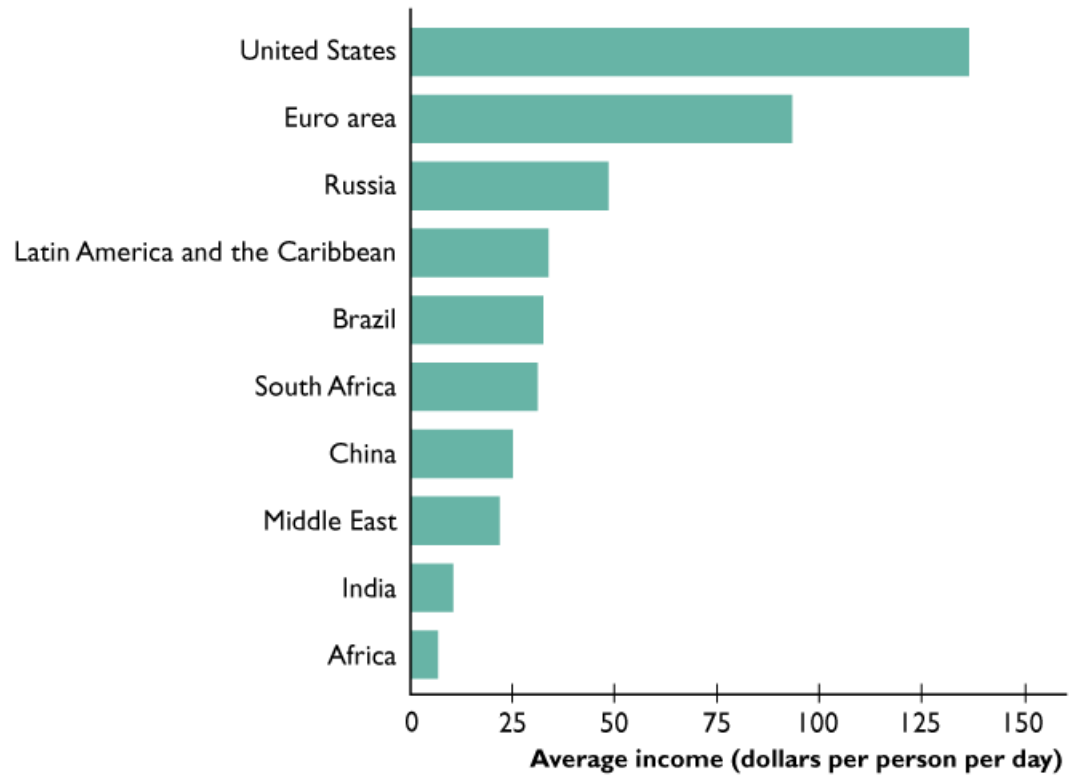
## 2.2 THE GLOBAL ECONOMY



In 2012, U.S. average income was \$137 a day.

It was \$93 a day in the Euro area and \$49 a day in Russia.

It was \$25 a day in China; \$10 in India, and \$7 in Africa.



## 2.3 THE CIRCULAR FLOWS

**Circular flow model** is a model of the economy that shows:

The circular flow of expenditures and incomes that result from decision makers' choices and

The way those choices interact in markets to determine what, how, and for whom goods and services are produced.

## 2.3 THE CIRCULAR FLOWS

### ■ Households and Firms

**Households** are individuals or people living together as decision-making units.

**Firms** are institutions that organize production of goods and services.

## 2.3 THE CIRCULAR FLOWS

### ■ Markets

A **market** is any arrangement that brings buyers and sellers together and enables them to get information and do business with each other.

**Goods markets** are markets in which goods and services are bought and sold.

**Factor markets** are markets in which factors of production are bought and sold.

## 2.3 THE CIRCULAR FLOWS



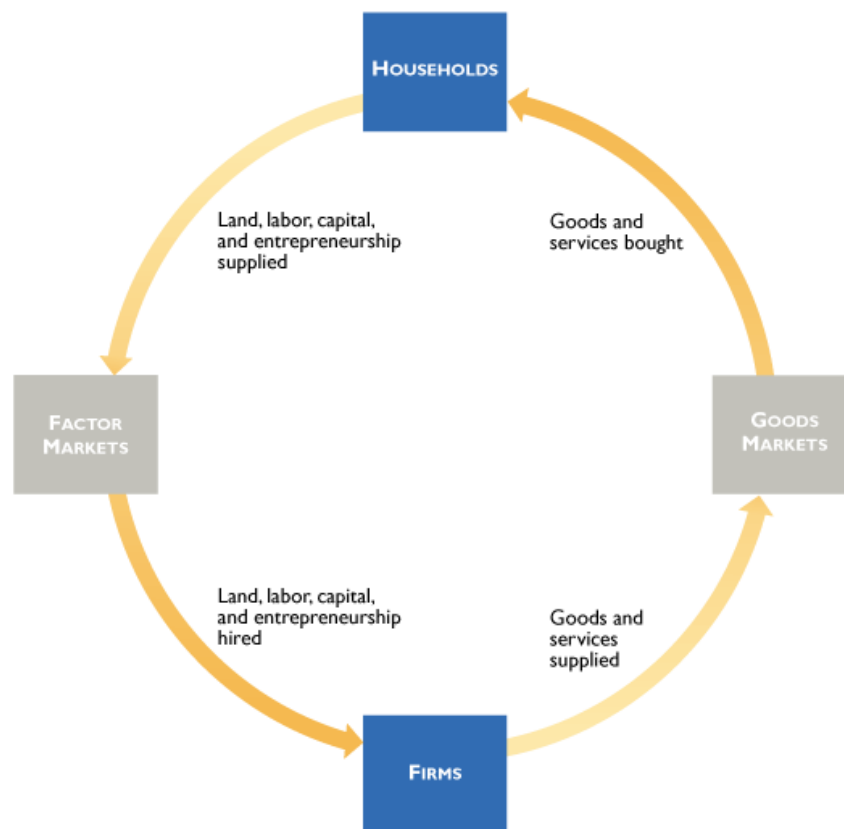
### ■ Real Flows and Money Flows

In factor markets:

- Households supply factors of production.
- Firms hire factors of production.

In goods markets:

- Firms supply goods and services produced.
- Households buy goods and services.

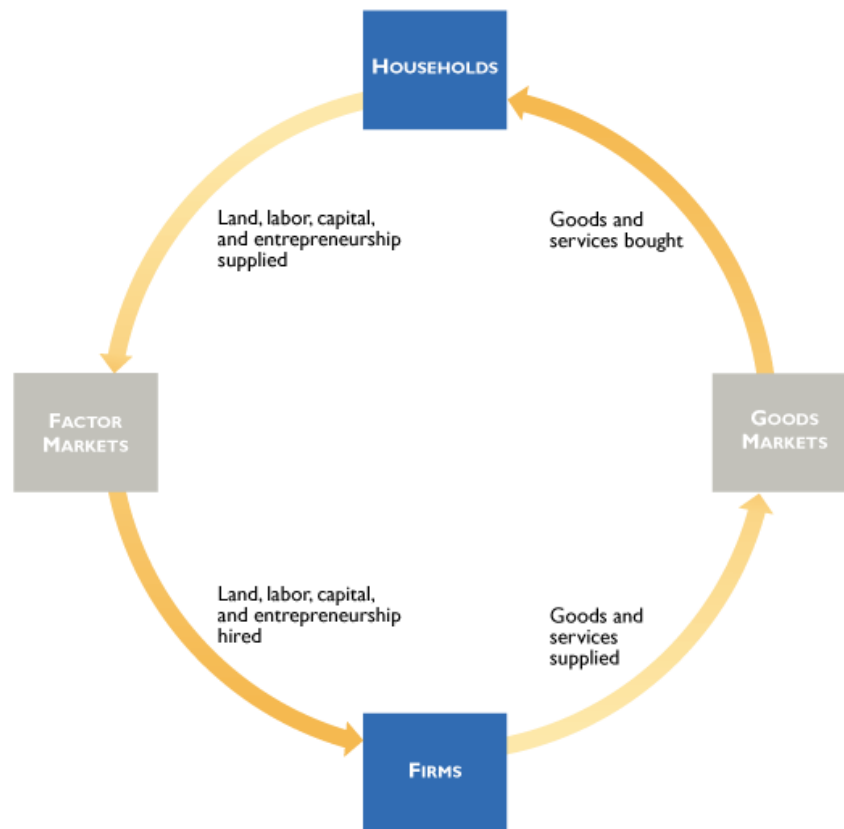


## 2.3 THE CIRCULAR FLOWS

### Real Flows

These are the real flows in the economy.

Money flows run in the opposite direction to the real flows.



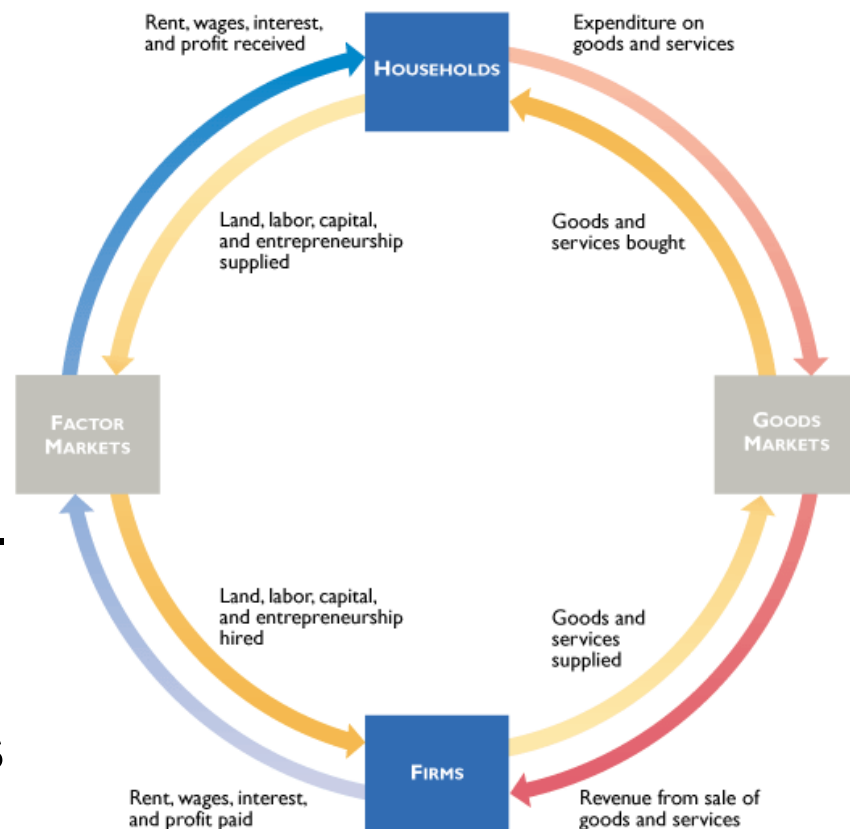


## 2.3 THE CIRCULAR FLOWS



### Money Flows

- Firms pay households incomes for the services of factors of production.
- Households pay firms for the goods and services they buy.
- These are the money flows.
- Blue flows are incomes.
- Red flows are expenditures



## 2.3 THE CIRCULAR FLOWS

### ■ Governments

We divide governments into two broad levels:

- Federal government
- State and local government

#### **Federal Government**

The federal government's major expenditures are to provide

1. Goods and services
2. Social Security and welfare benefits
3. Transfers to state and local governments

## 2.3 THE CIRCULAR FLOWS

The federal government finances its expenditures by collecting taxes.

The main taxes are

1. Personal income taxes
2. Corporate (business) taxes
3. Social Security taxes

In 2012, the federal government spent \$3 trillion—about 19 percent of the total value of all the goods and services produced in the United States in that year.

Taxes raised less than \$3 trillion—the government had a deficit.

## 2.3 THE CIRCULAR FLOWS

### State and Local Government

State and local governments expenditures provide

1. Goods and services
2. Welfare benefits

State and local governments finance these expenditures by collecting taxes.

The main taxes levied are

1. Sales taxes
2. Property taxes
3. State income taxes

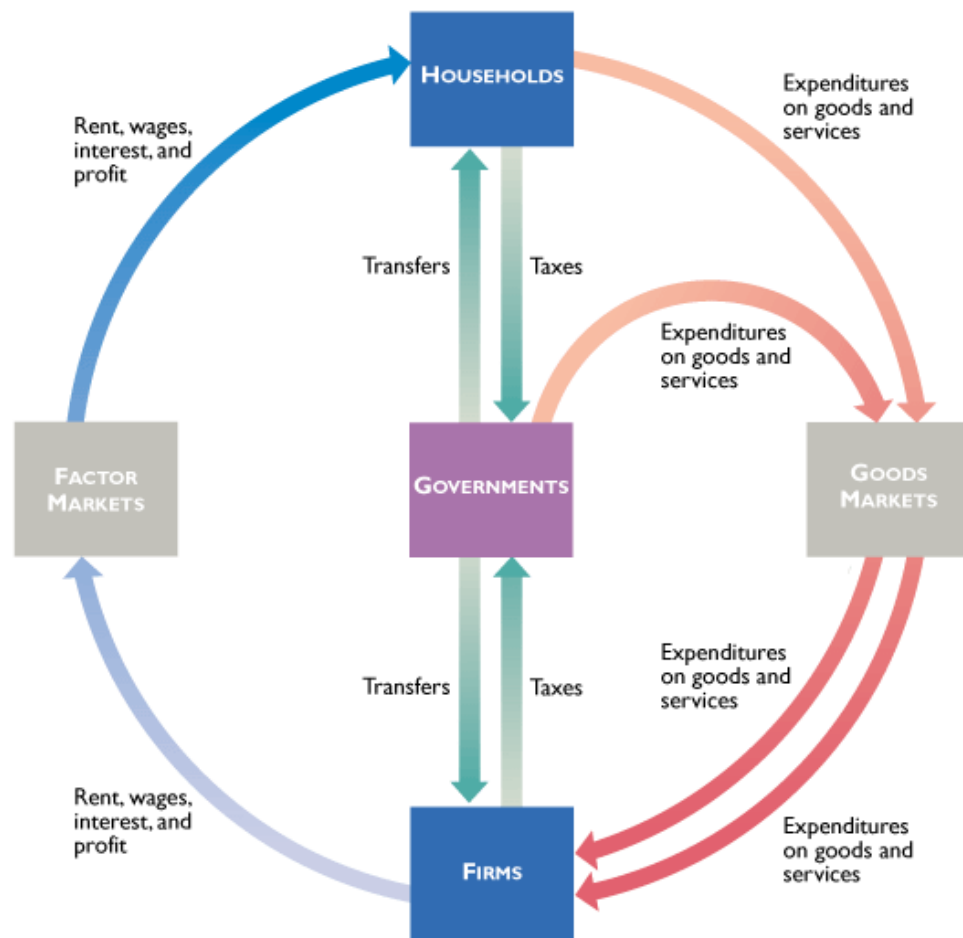
## 2.3 THE CIRCULAR FLOWS



### ■ Governments in the Circular Flow

Households and firms pay taxes and receive transfers.

Governments buy goods and services from firms.



## 2.3 THE CIRCULAR FLOWS

### ■ Circular Flows in the Global Economy

Households and firms in the U.S. economy interact with households and firms in other economies in two main ways:

They buy and sell goods and services and they borrow and lend.

We call these two activities:

- International trade
- International finance

## 2.3 THE CIRCULAR FLOWS

### International Trade

Many of the goods that you buy were not made in the United States—your iPod, Wii games, and Nike shoes.

The goods and services that we buy from firms in other countries are U.S. *imports*.

Much of what is produced in the United States doesn't end up being sold here—Boeing sells most of the airplanes it makes to foreign airlines.

The goods and services that we sell to households and firms in other countries are U.S. *exports*.



## 2.3 THE CIRCULAR FLOWS

### International Finance

When firms or governments want to borrow, they look for the lowest interest rate available.

Sometimes, that is outside the United States.

Also, when the value of U.S. imports exceeds the value of U.S. exports, the United States must borrow from the rest of the world.

## 2.3 THE CIRCULAR FLOWS



Households and firms in the U.S. economy interact with those in the rest of the world in goods markets and financial markets.

U.S.  
ECONOMY

FINANCIAL  
MARKETS

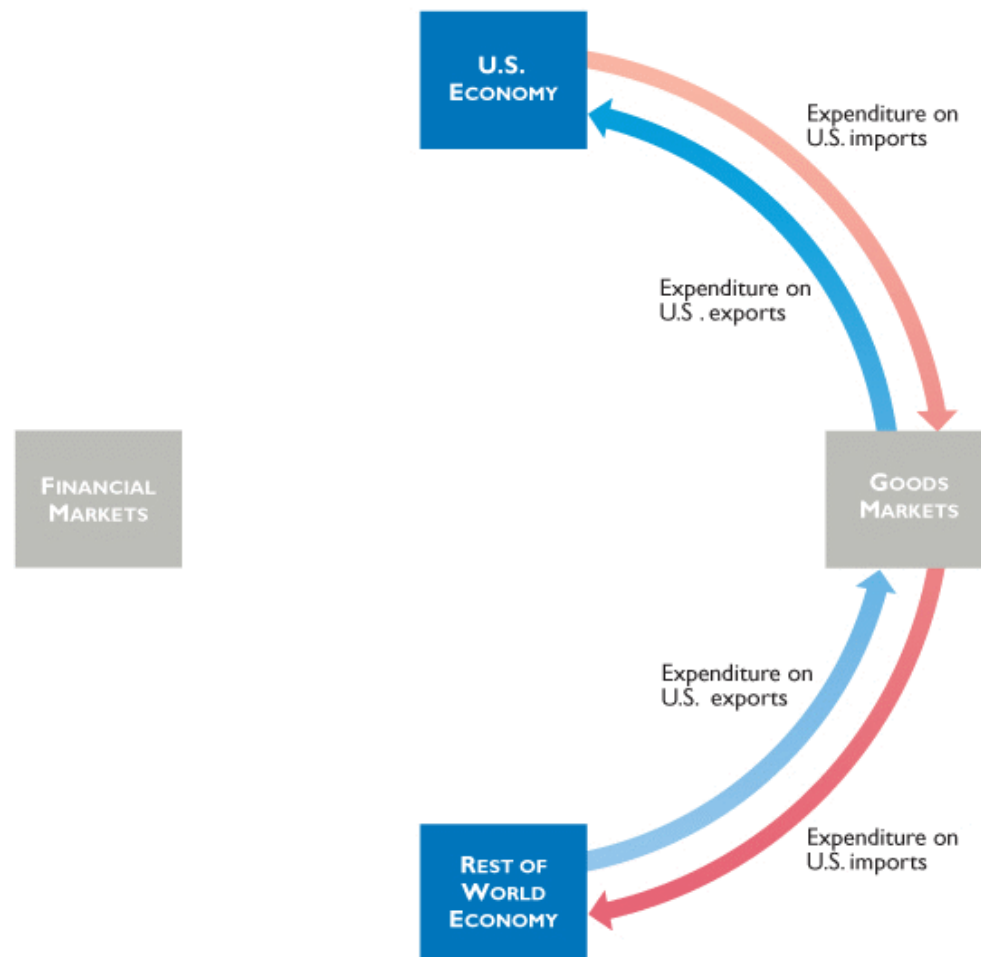
GOODS  
MARKETS

REST OF  
WORLD  
ECONOMY

## 2.3 THE CIRCULAR FLOWS

The red flow shows the expenditure by Americans on imports of goods and services.

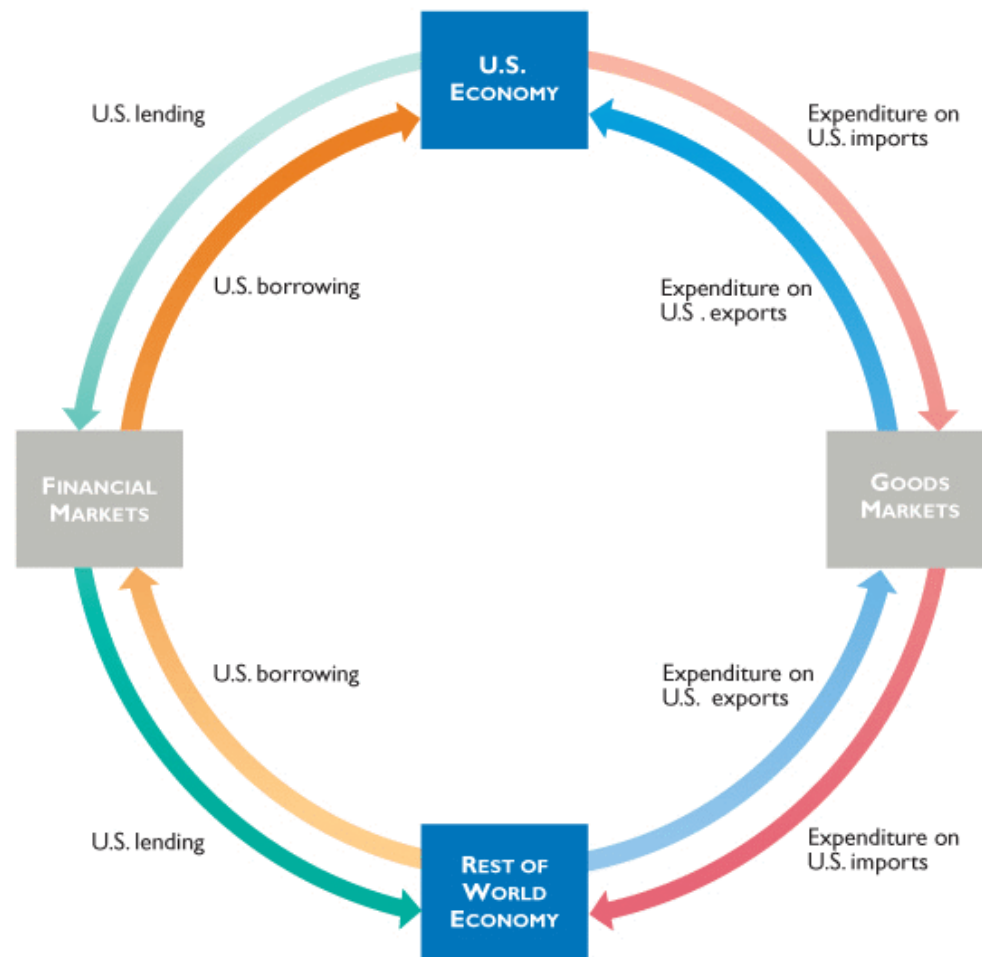
The blue flow shows the expenditure by the rest of the world on U.S. exports (other countries' imports).



## 2.3 THE CIRCULAR FLOWS

The green flow shows U.S. lending to the rest of the world.

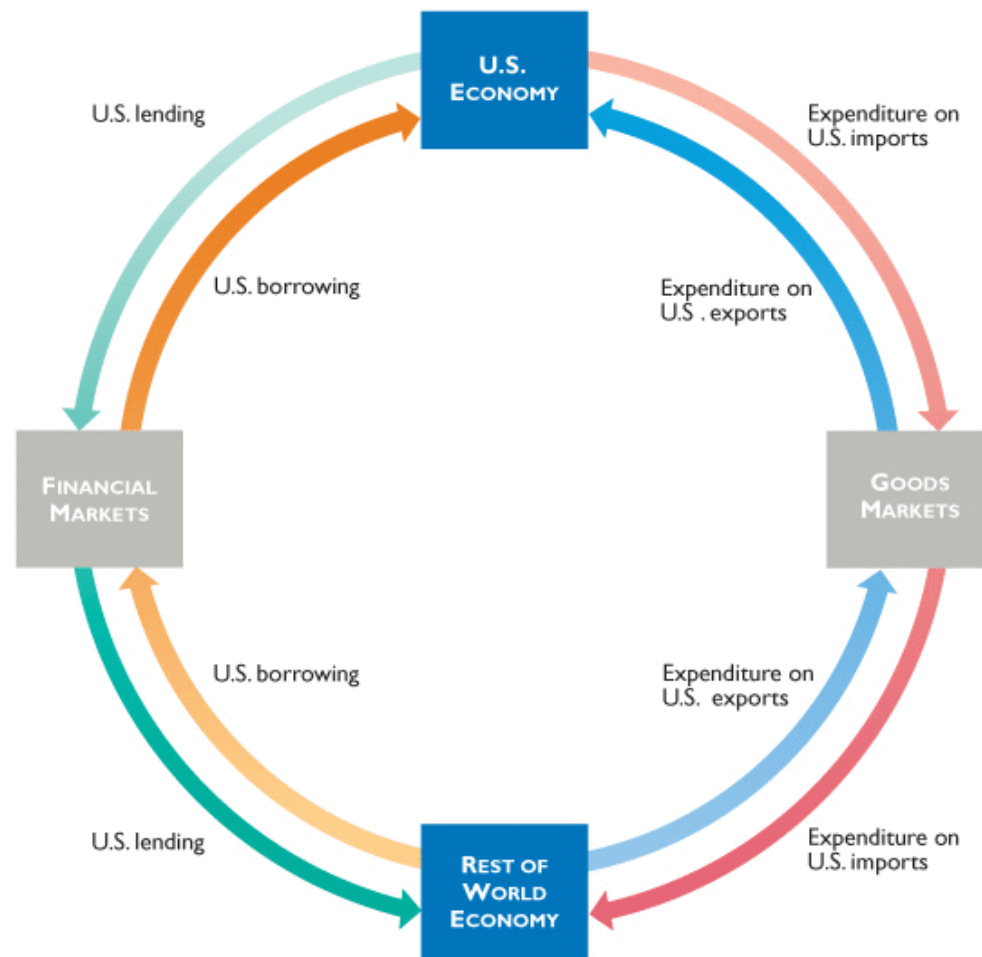
The orange flow shows U.S. borrowing from the rest of the world.



## 2.3 THE CIRCULAR FLOWS

These international trade and international finance flows tie nations together.

Global booms and slumps are transmitted through these flows.



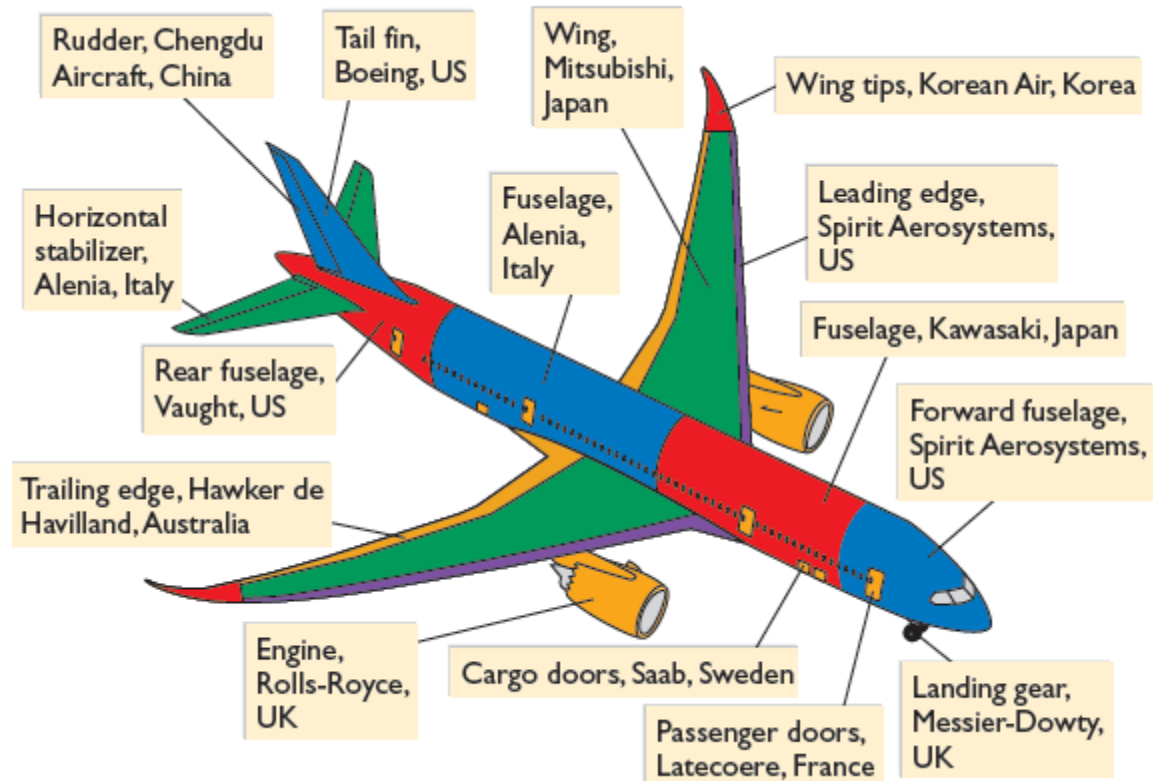


# EYE on the DREAMLINER

## Who Makes the Dreamliner?

Boeing wants to manufacture the Dreamliner at the lowest possible cost.

Boeing achieves this goal by having more than 400 firms on 4 continents make its components.

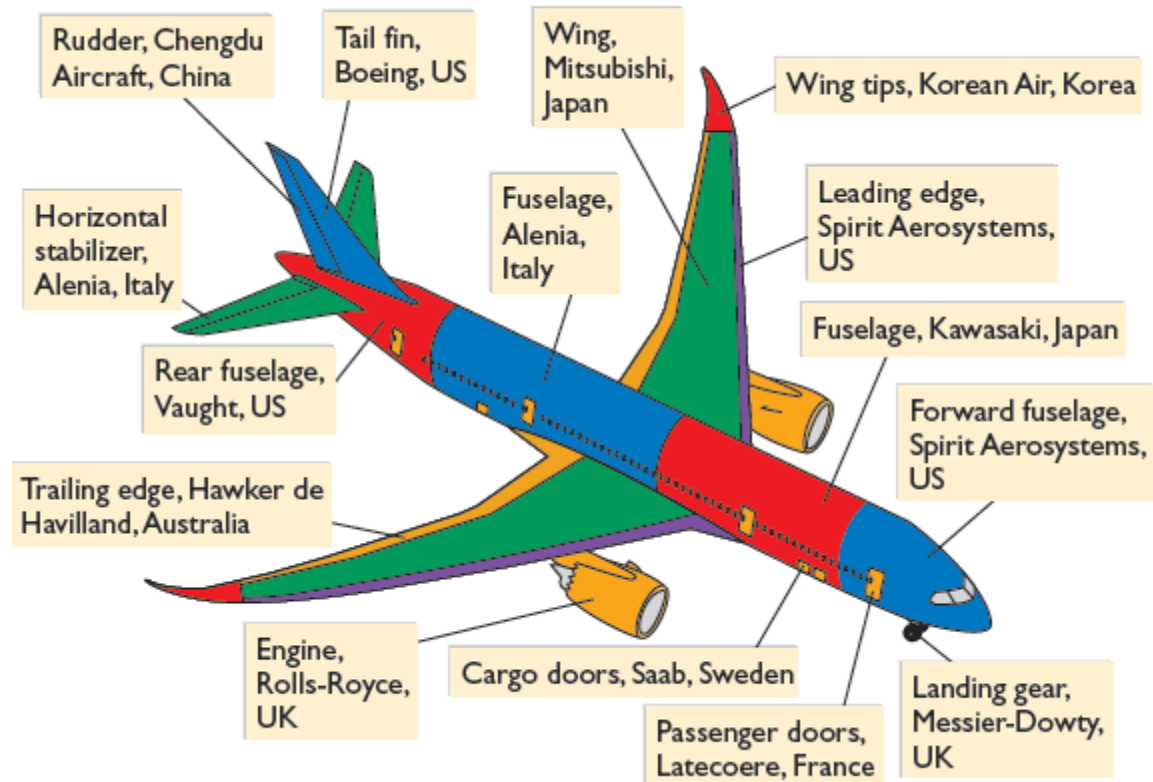




# EYE on the DREAMLINER

## Who Makes the Dreamliner?

Boeing and the 400-plus firms make decisions and pay their workers, investors, and raw material suppliers to play their parts in influencing *what*, *how*, and *for whom* goods and services are produced.





# EYE on the DREAMLINER

## Who Makes the Dreamliner?

All these decisions are made in self-interest and the Dreamliner is produced at the lowest possible cost.

