The Institutional Structure of an Economy

 P. LeBel

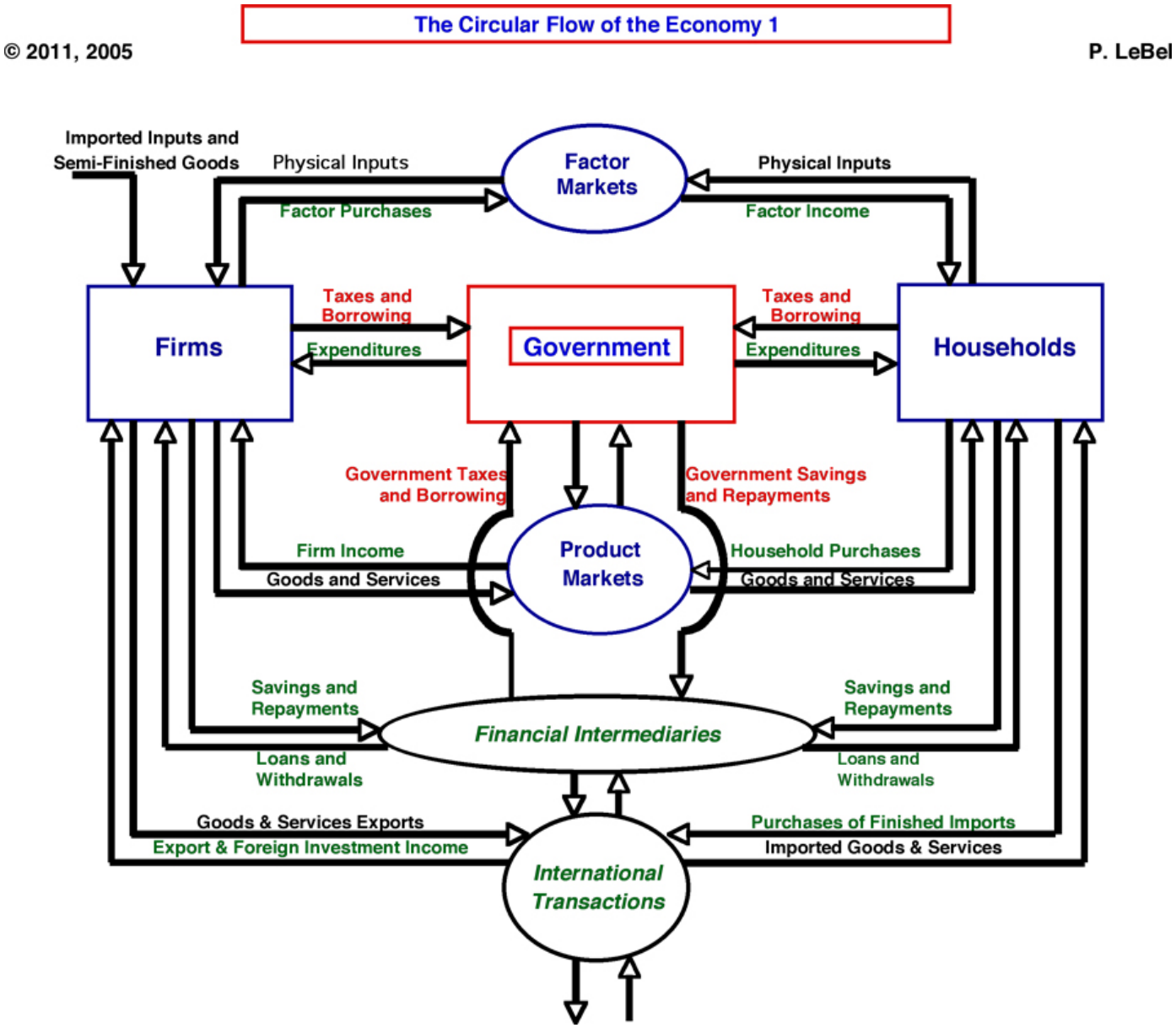
While scarcity represents the core of economics, how institutions allocate scarce resources reflects perceptions and attitudes toward risk. The different configurations below constitute alternative institutional structures for managing risk. Ultimately, how risks are perceived and acted upon shapes not only the static configuration of institutions, but also the dynamics of economic growth.

Market economies view government as an arbiter of contractual relationships. Economic efficiency (both technical and allocative) are the principal criteria by which market economies are judged. Distortions in market pricing (such as negative and positive externalities, and imperfect competition) are viewed as minor constraints on achieving economic efficiency.

In a market economy, questions of fairness are confined to equality of access, not equality of outcomes. As long as equality of opportunity is guaranteed through an objectively defined and upheld legal system, inequalities in outcomes are considered to be a reflection of differences in the marginal productivities of factors of income (land, labor, capital, and entrepreneurship). In this view, they do not require public sector intervention to achieve an optimal degree of distributive justice.

The Structure of Factor Markets

Inputs in Production Functions and Technology:	Factor Market Payments
Land - N	Rent -R
Labor - L	Wages - W
Capital - K	Interest - I
Entrepreneurship - E	Profit - Pr


The Circular Flow of the Economy 1
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Imported Inputs and Semi-Finished Goods
Physical Inputs
Factor Markets
Physical Inputs
Factor Purchases
Factor Income
Firms
Taxes and Borrowing
Expenditures
Government
Taxes and Borrowing
Expenditures
Households
Government Taxes and Borrowing
Government Savings and Repayments
Firm Income
Goods and Services
Product Markets
Household Purchases
Goods and Services
Savings and Repayments
Financial Intermediaries
Savings and Repayments
Loans and Withdrawals
Loans and Withdrawals
Goods & Services Exports
Export & Foreign Investment Income
International Transactions
Purchases of Finished Imports
Imported Goods & Services

The Circular Flow of the Economy 2

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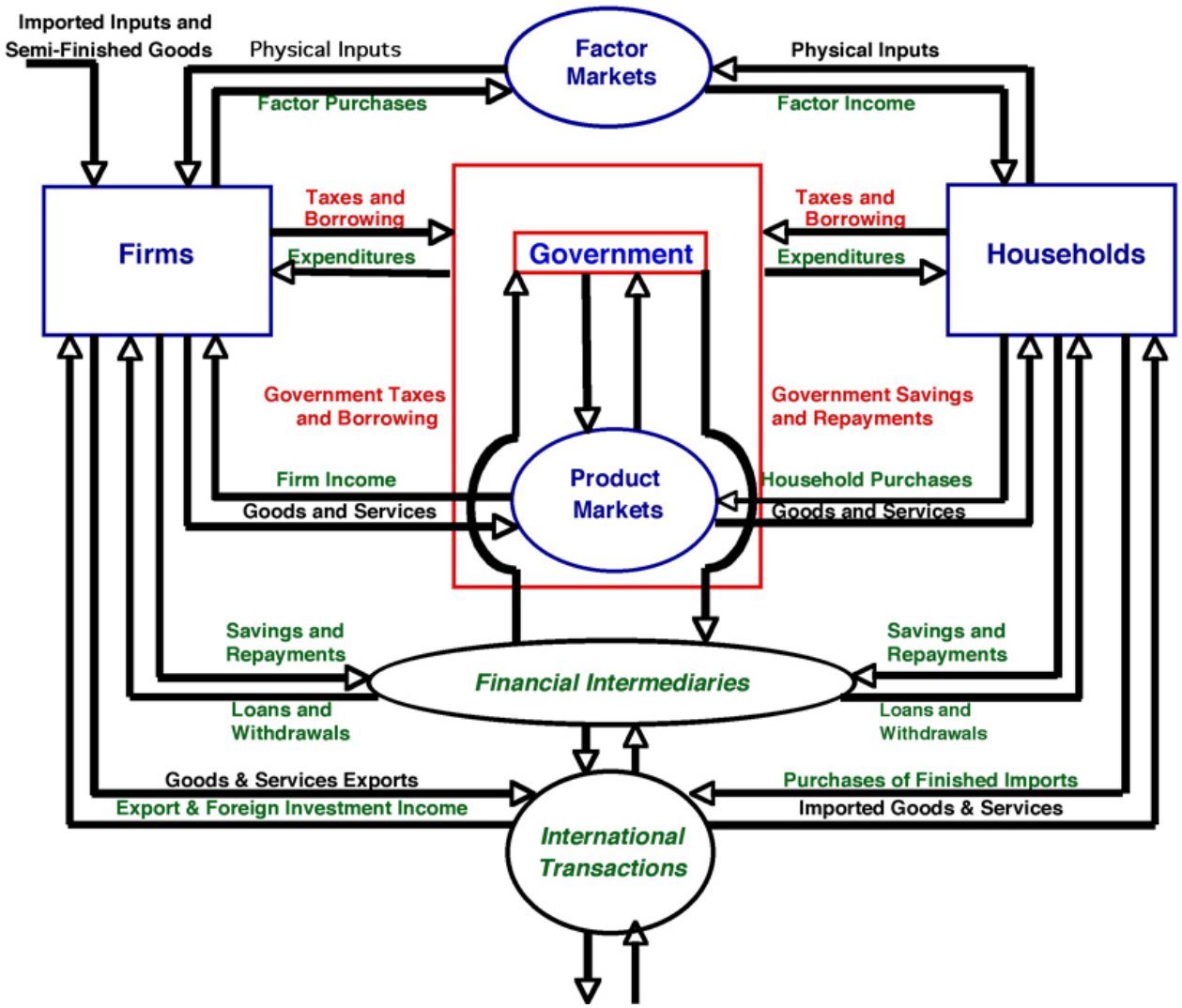

The Circular Flow of the Economy 3

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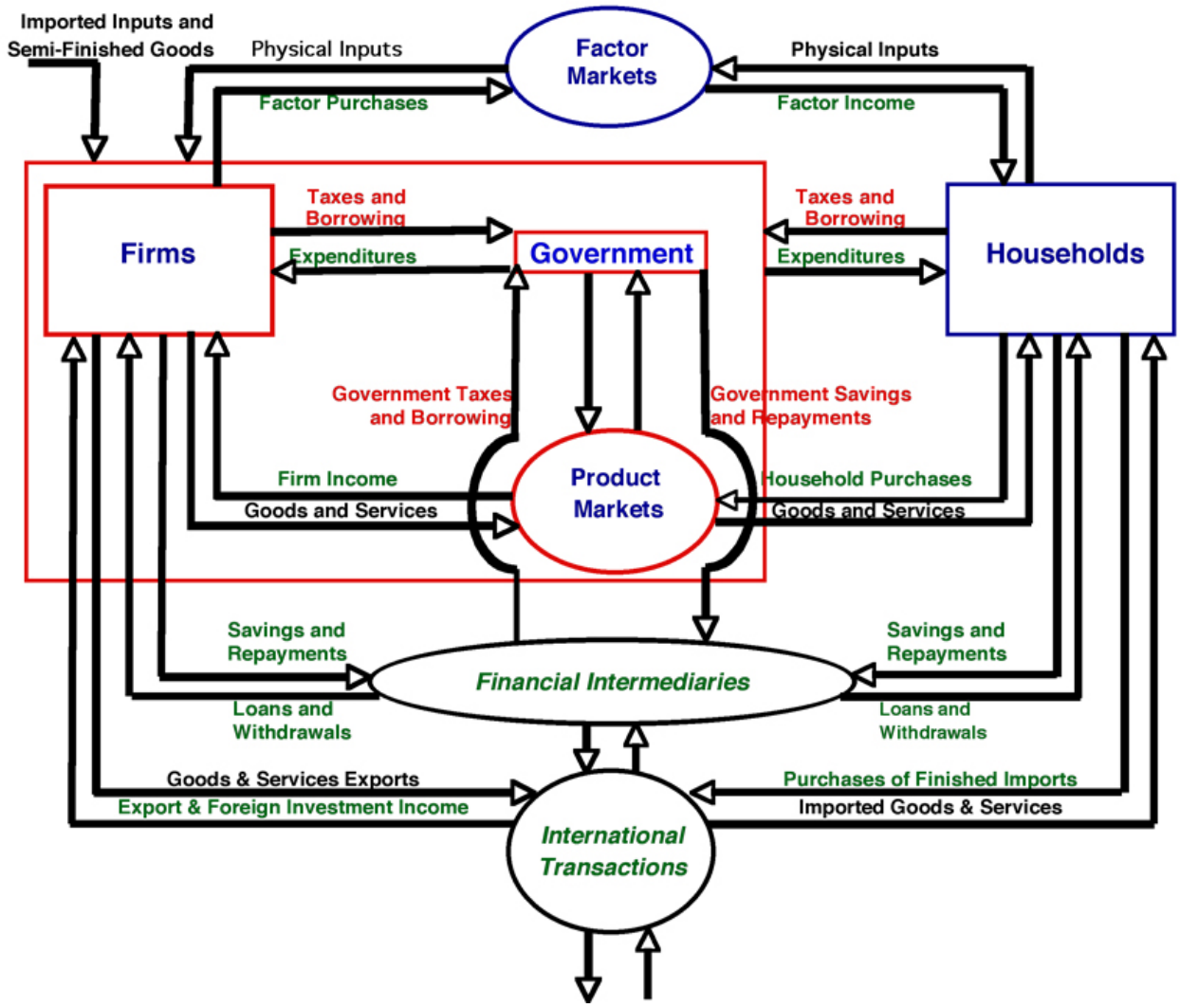

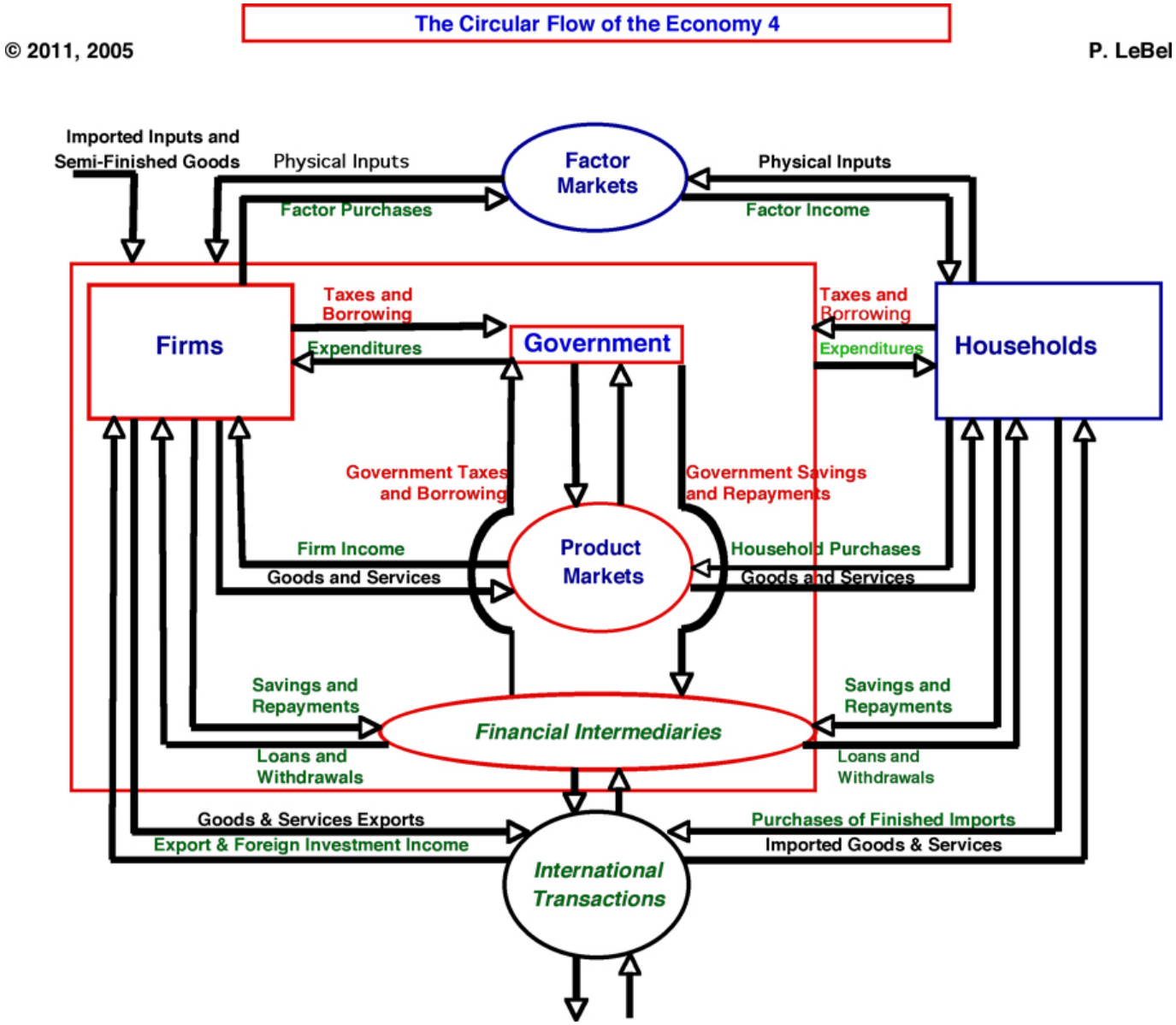
The Circular Flow of the Economy 4
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P. LeBel
Imported Inputs and Semi-Finished Goods
Physical Inputs
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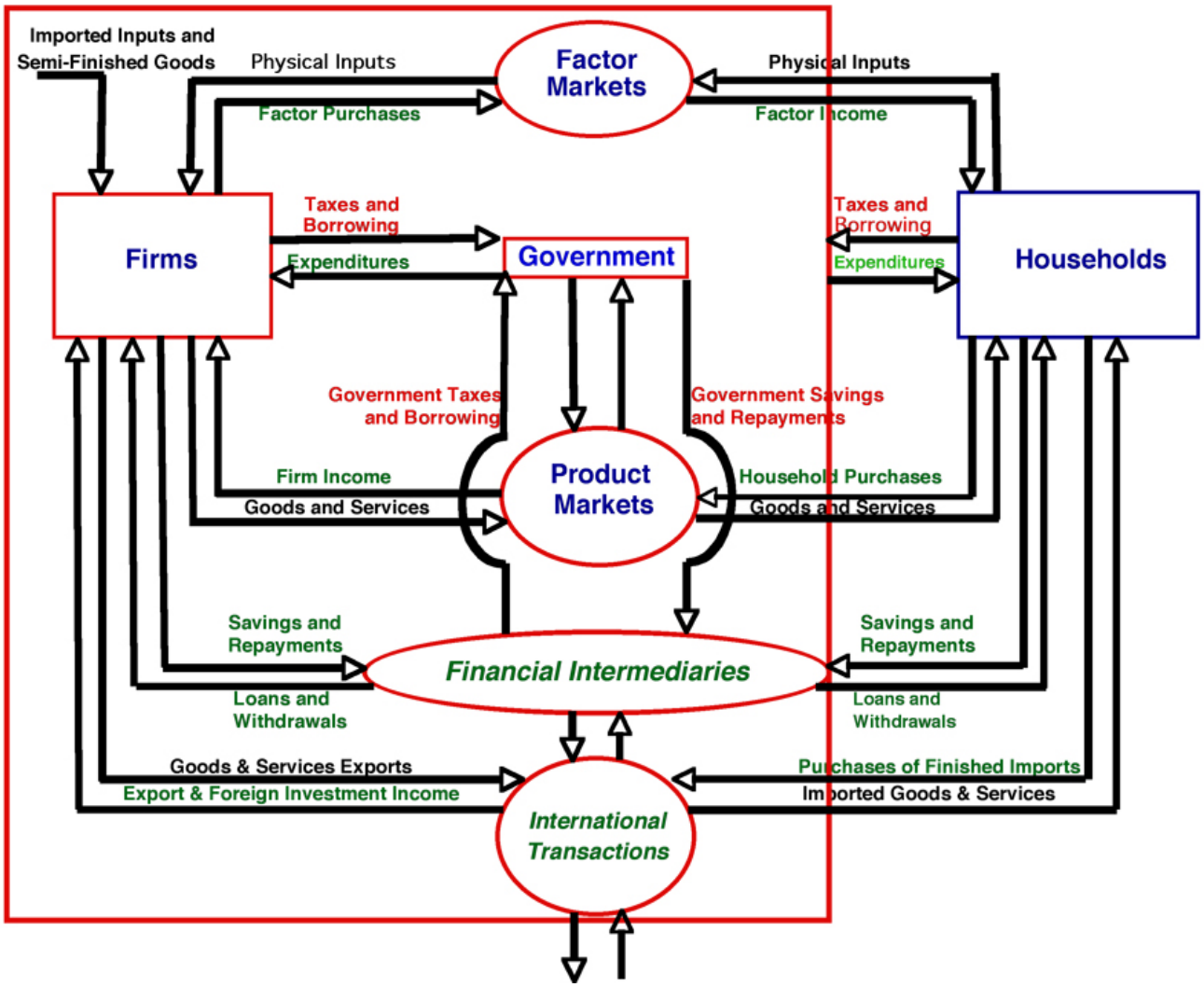
Each extension of public sector intervention transforms an economy from a market institutional structure to a state-based economy. Critics view any extension of government intervention as restricting individual freedom, in which both civil and economic liberties may be curtailed and in which investment innovation may result in lower economic growth. Defenders of government intervention view the scale and impact of risk on both economic efficiency and equity and for which varying degrees of regulation, taxation, and public sector spending are needed correctives if sustainable and equitable growth are to be achieved.

The Circular Flow of the Economy 5

 P. LeBel

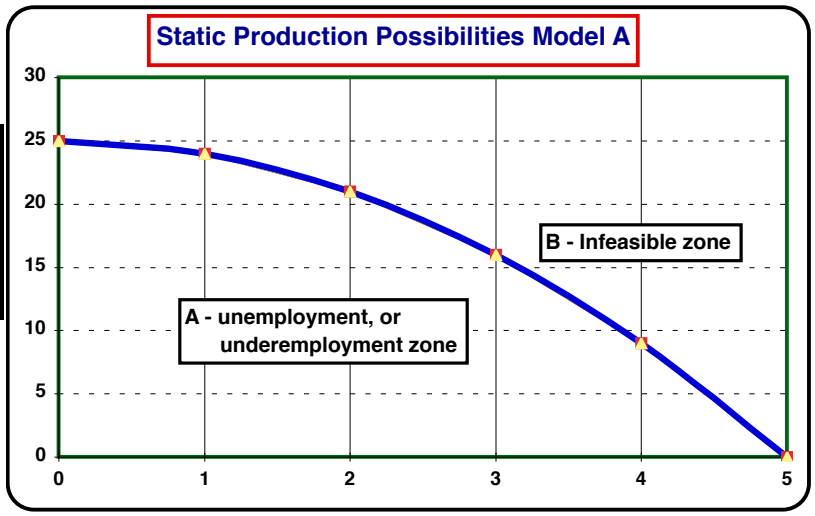


Alternative Production Possibilities

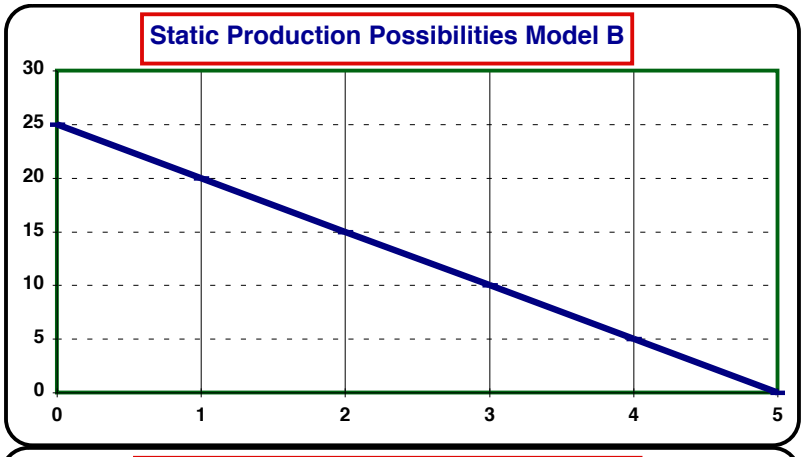
 P. LeBel

The production possibilities model illustrates the principles of scarcity, opportunity costs, and economic growth. The shape of the production possibilities curve at one moment in time indicates whether the opportunity cost is increasing, constant, or decreasing. Input specialization indicates that there will be increasing opportunity costs, and thus the production possibilities curve will be concave, or bow-shaped outward. If resources are perfectly shiftable because there is no input specialization, then we will have a straight-line production possibilities curve. If we have a mismatched allocation of inputs, we may have the alternative extreme of decreasing opportunity costs, in which case it is always better to be in a different position than you actually are.

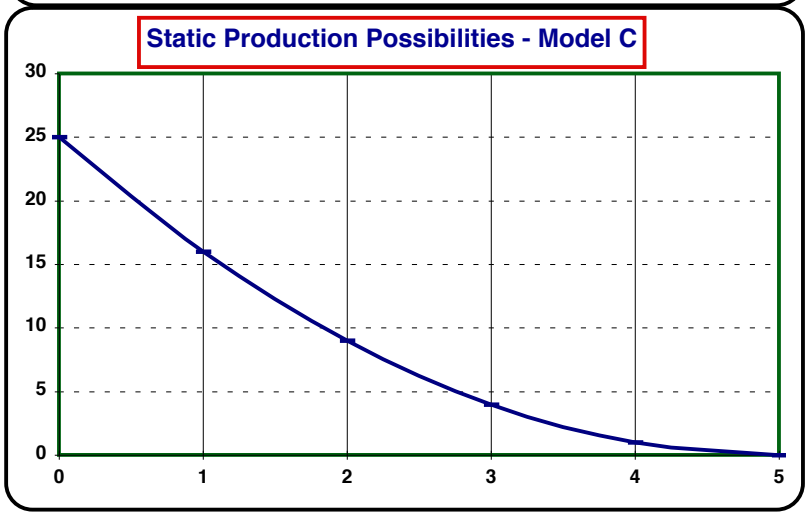
	A	B	C	D	E	F
K	25	24	21	16	9	0
C	0	1	2	3	4	5
Calculation of the Opportunity Cost:						
dk/dc=		1.00	3.00	5.00	7.00	9.00
dc/dk=		1.00	0.33	0.20	0.14	0.11



	A	B	C	D	E	F
K	25	20	15	10	5	0
C	0	1	2	3	4	5
Calculation of the Opportunity Cost:						
dk/dc=		5.00	5.00	5.00	5.00	5.00
dc/dk=		0.20	0.20	0.20	0.20	0.20



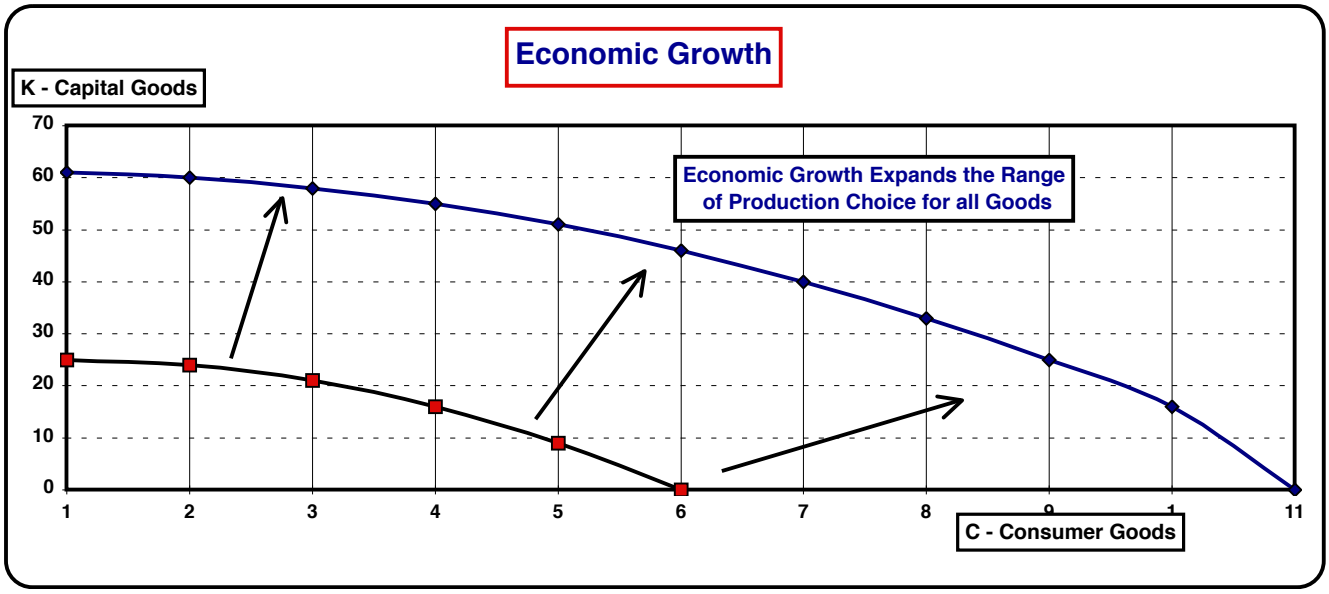
	A	B	C	D	E	F
K	25	16	9	4	1	0
C	0	1	2	3	4	5
Calculation of the Opportunity Cost:						
dk/dc=		9.00	7.00	5.00	3.00	1.00
dc/dk=		0.11	0.14	0.20	0.33	1.00



Achieving Economic Growth

 P.LeBel

Economic growth can occur in four possible ways. How much growth by each factor will depend on economic incentives such as savings and investment, technological innovation, and policies toward resource specialization and international trade.



Determinants of Economic Growth

1. **An increase in the stock of inputs - land, labor, capital, entrepreneurship**
   Examples: growth in the labor force, capital stocks, new natural resource discoveries
2. **Technological innovation that produces a more efficient use of inputs**
   Examples: investment in energy conserving machinery and buildings, faster computers
3. **Input specialization**
   Examples: education and training in computers, biotechnology, space exploration; robotics
4. **International trade**
   Examples: WTO commitments to reduce tariffs, quotas, and non-tariff barriers