

## **Chapter 2: The Market System and the Circular Flow**

The problem of scarcity requires us to decide what to produce, how to produce goods, and how those goods will be allocated to members of society. But societies must determine who will have the power to make those decisions: government, the people, tradition, or some combination of these factors. Chapter 2 introduces the major economic systems and the circular flow model that illustrates a market economy.

The most important concept of the chapter for the AP Economics exams is the circular flow model. Households sell factors of production to firms in the resource (factor) market, while firms sell finished products to households in the product market. Adam Smith, the father of economics, argues the “invisible hand of self-interest” directs the market economy, allowing the private sector to make the what, how, and for whom decisions without requiring a government bureaucracy to do so. Private property rights, the profit motive for entrepreneurs, and competition are also key elements of market economies, while equality of income and condition are not.

Material from Chapter 2 is likely to appear in a very limited form on the AP Economics exams. A question or two about market incentives may appear on the AP Microeconomics Exam, while the circular flow diagram is more likely to appear in a question on the AP Macroeconomics Exam. An understanding of the circular flow model and differences among economic systems is important for success in this chapter.