

Chapter 2 - Answering the Three Economic Questions

OBJECTIVES

- Identify the three key economic questions of what to produce, how to produce, and who consumes what is produced.
- Analyze the societal values that determine how a country answers the three economic questions.
- Explain the characteristics of traditional, command, and market economies and describe the societal values that influence them.

Scarcity forces societies and nations to answer some hard economic questions.

Economic System – the method used by a society to produce and distribute goods and services.

- What are that particular society's goals and values?

People in any economy face three major economic decisions:

1. What goods and services should be produced, and how much of them?
2. How should these goods and services be produced?
3. Who will get the goods and services that are produced?

In our economy, the people who own or can get the resources decide what to produce.

What and How Much to Produce

In our economy, the people who own or can get the resources decide what to produce.

- Any decision about what goods or services to produce is based on a prediction of what people will want to consume.

How much to produce is also decided by the owner of the resources.

How to Produce Goods and Services

In what way will land, labor, and capital be combined to produce the goods and services people want?

In making decisions about how to produce, people usually want to choose the combination of resources that will be the least costly.

- This has led to the growth of technology

The Role of Technology

- Plays an increasingly important part in the decision that people make about how to produce goods and provide services.
- Example: seeds which are engineered to produce larger crops, electronic advancements which gave us robots to use in factories, etc...
- Computers keep records, make calculations, and speed up many jobs.

Who Will Get What Is Produced

People must find a way to decide how all the goods and services will be divided up.

- Wants are always greater than the resources available to satisfy them...this leads to a very important and difficult choice of who gets what.

Should goods and services be divided equally among all people?

Should people receive goods and services on the basis of what they say they want?

Should a small group of people decide who is to receive which goods and services?

Should people who own more resources and produce more products get more goods and services than people who own or produce less?

Societies answer the three economic questions based on their values.

| Economic Goals | |
|---|---|
| Economic efficiency | Making the most of resources |
| Economic freedom | Freedom from government intervention in the production and distribution of goods and services |
| Economic security and predictability | Assurance that goods and services will be available, payments will be made on time, and a safety net will protect individuals in times of economic disaster |
| Economic equity | Fair distribution of wealth |
| Economic growth and innovation | Innovation leads to economic growth, and economic growth leads to a higher standard of living. |
| Other goals | Societies pursue additional goals, such as environmental protection. |

In your notes:

Define each term and give an example:

1. **Producer**
2. **Product**
3. **Market**
4. **Consumer**

Three Types of Economies

Explain in your notes:

In human history there have been generally four basic types of economic systems:

- 1) traditional economy
 - 2) command economy
 - 3) market economy
 - 4) mixed economy
- These systems are four different ways a society can organize production, distribution, and consumption to solve the economic problem of scarcity.

Traditional economy...where the basic economic decisions are made according to long-established ways of behaving that are unlikely to change

- Customs are passed along from elders to youth
- Tradition answers the question of what and how much to produce
- Tribal members may hunt and gather in the same areas, use the same tools, weapons, and methods to get food, and the same methods to prepare the food and cook it
- Tribes customs determine who gets what is produced
- Individuals or families usually own their own resources, such as land, tools, and labor
- Very little change in the economy over time, due to the little freedom that tradition allows
- Traditional economies exist today in Central America, South America, Africa, Asia

Chapter 2 –The Free Market

OBJECTIVES

- **Explain why markets exist.**
 - **Analyze a circular flow model of a free market economy.**
 - **Understand the self-regulating nature of the marketplace.**
 - **Identify the advantages of a free market economy.**
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- *Market*...an arrangement that allows buyers and sellers to exchange things.
 - Farmers market
 - Sporting goods store
 - New York Stock Exchange
 - Fred Meyer
 - Community bulletin board advertising babysitting services
 - Markets exist because no one is self sufficient
 - None of us produces all we require to satisfy our needs
 - Markets allow us to exchange the things we have for the things we want
 - *Specialization*...the concentration of productive efforts of individuals and firms on a limited number of activities

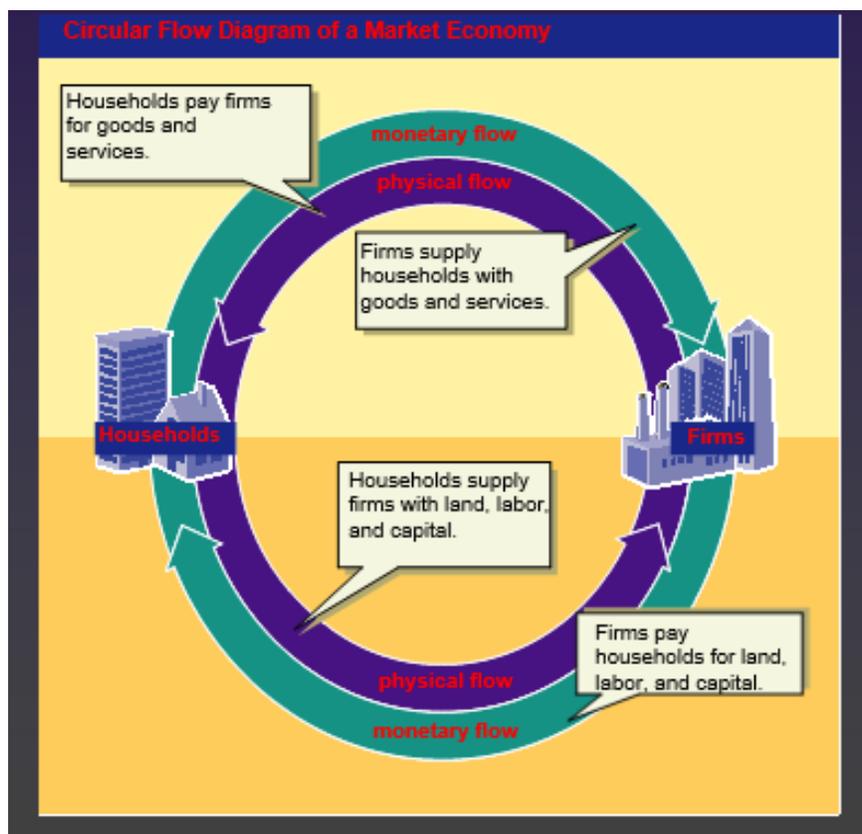
- Buying & Selling - we need markets to sell what we have and buy what we want
Trading income (what your earn) for what you consume
- *Free Market economy*...system in which private individuals own the factors of production and are free to make their own choices about production, distribution, and consumption.
 - Voluntary Exchanges
 - The economy of the United States is based on the free market system
 - All economic decisions are made through a kind of bargaining process that takes place in *markets* (where buyers and sellers agree to exchange goods and services)
 - In a market, the value of what you have to offer sets the value of what you can get

No one person or group runs a market economy

Individuals answer the three key economic questions

Everyone takes part in running it by making economic decisions

- In a *market economy*, people are free to decide how to use land, labor, and capital
 - Also free to start their own business and to choose what jobs they want to work at
 - The major economic decisions are made by individuals, not by government command or tradition
- We can represent a free market economy in a special kind of drawing called a **Circular Flow Diagram**
 - In a free market economy, households and business firms use markets to exchange money and products.
 - Households own the factors of production and consume goods and services.



- *Competition*...the struggle among producers for the dollars of consumers plays an important part in a market economy

Producers compete to satisfy the wants of consumers, buyers compete to get the products they want, workers compete for jobs

- Profit motive influences the decisions people make in a market economy
 - *Profit*...is the difference between what it costs to produce something and the price the buyer pays for it
 - The desire to make a profit also leads people to *invest* in a business...use your money to help a business get started or grow, with the hope that the business will earn a profit that you can share
 - *Free enterprise*...refers to the system in which individuals in a market economy are free to undertake economic activities with little or no control by the government

Advantages of the Free Market

1. **Economic efficiency** -
 - A free market is self-regulating.
 - Responds efficiently to rapidly changing conditions.
 - Producers make only what consumers want, when they want it, and at prices they are willing to pay for it.
2. **Economic freedom** -
 - Free market economies have the highest degree of economic freedom of any system.
 - Including the freedom of workers to work where they want, of firms to produce what they want, and of individuals to consume what they want.
3. **Economic growth** -
 - Competition encourages innovation, which encourages growth.
 - Entrepreneurs seek profitable opportunities, which contribute new ideas and innovation.
4. **Additional goals** -
 - Free markets offer a wider variety of goods and services.
 - producers have greater incentive to meet consumers desire.

Answer these questions in your notes:

1. Explain what comes to mind when you hear the term *self-interest*.
2. How might *self-interest* motivate the marketplace?
3. What is a *voluntary exchange*? How might this incorporate *self-interest* and be important in a free market?

**Hint: look at the blue 'fast fact' box on p. 32.*

Free enterprise...refers to the system in which individuals in a market economy are free to undertake economic activities with little or no control by the government

Capitalism...system in which people make their own decisions about how to save resources as capital, and how to use their capital to produce goods and provide services

Chapter 2 -Centrally Planned Economies

OBJECTIVES

- Describe how a centrally planned economy is organized.
 - Analyze the centrally planned economy of the former Soviet Union.
 - Identify the problems of a centrally planned economy.
- *Centrally Planned (Command) economy*...where the government or a central authority owns or controls the factors of production and makes the basic economic decisions
 - Government usually has charge of important parts of the economy, such as transportation, communications, banking, and manufacturing
 - Farms, stores, etc...are government controlled
 - Government may also set wages and decide who will work at which jobs
 - Examples of command economies include Ancient Egypt, the former USSR, communist China, Cuba under Fidel Castro, etc...
 - A central planning group makes most of the decisions about how, what, and how much to produce
 - Result is that only those products that the government chooses will be available for people to consume
 - What gets produced depends on the goals and values of those in power
 - Greedy dictator, etc...
- Centrally Planned (Command) economies oppose:
 1. Private property
 2. Free market pricing
 3. Competition
 4. Consumer choice
 - The central government, rather than the individual producers and consumers in markets, answers the key economic questions of production and consumption.
 - Central bureaucracy makes all the decisions:
 - What to produce
 - How to produce them
 - Who gets them
 - It is up to the bureaucrats to ensure that each firm has enough raw materials and workers to meet its production goals
- Free market forces of self-interest and competition are absent in Command Economies
 - Consumers do not have consumer sovereignty
 - Socialism and Communism
 - *Socialism* – social and political philosophy based on the belief that democratic means should be used to distribute wealth evenly throughout a society.
 - Real equality = when political and economic equality are brought together
 - Socialism requires a high degree of central planning to achieve economic equality – NOT a true “democracy,” though might allow for some democratic principles
 - Gov’t owns major industries in Socialism.
 - *Communism* – a political system that arose out of Socialism.

- Characterized by a centrally planned economy with all economic and political power resting in the hands of the central government.
 - Gov't owns all property.

5 BIG Differences Between Socialism and Communism:

SOCIALISM

- Socialism is religion-neutral, supports secularism.
- Allows elections, but more regulated.
- Civil rights similar to ours (though not similar freedoms).
- Does well in Standard of Living.
- The Dr. makes more than the street cleaner (difference in wages)

COMMUNISM

- Communism outlaws religion.
- Authoritarian Dictatorships.
- Civil rights suspended.
- Does poorly on Standard of Living - economy shrinks.
- Everybody makes the same.

- Communists believe that socialism can only come about through violent revolution.
 - *Authoritarian* – requires strict obedience to an authority (dictator, military, etc...)
 - Communist nations in history have always been dominated by a central authority – a political party or dictator.
 - Former USSR, China, Cuba, etc..

- Problems of Centrally Planned (Command) Economies:
 - Poor quality goods, serious shortages of non-priority good and services, and diminishing production.
 - Performance always falls short of the ideals upon which the system is built.
 - Systems cannot meet the needs or wants of consumers.
 - Government owns all the factors of production: workers lack the incentive to work hard.
 - System does not reward innovation: actively discourages any kind of change.
 - The large bureaucracy necessary to run a centrally planned system cannot react to consumer demands (too many distribution and production decisions). Overly complicated.
 - Individual freedoms are sacrificed in order to pursue greater societal goals

Chapter 2 – Modern Mixed Economies

OBJECTIVES

- Explain the rise of mixed economic systems.
- Interpret the circular flow model of a mixed economy.
- Compare the mixed economies of various nations along a continuum between centrally planned and free market systems.
- Understand the role of free enterprise in the economy of the United States.

- Most modern mixed economies blend the free market system with government intervention, or involvement, in the marketplace.
- *Mixed Economies*...an economy that is a mixture of the three basic systems.
- Centrally planned economies are cumbersome
 - Do not adequately meet the needs of consumers
 - Limit freedom (economically, societally, politically, etc...)
- Market economies have drawbacks
 - Examples: A rental fee at community library? Buy a ticket to use a highway?

Laissez faire – the doctrine that government generally should not intervene in the marketplace.

- Even Adam Smith believed that government would need to intervene in a LIMITED degree in the marketplace.
- HOW WELL can the free market provide for national defense? For roads and highways? Education? Postal service?

Government Intervention

- Examples: laws protecting property rights, enforcing contracts, patent laws, laws that insist on competition, etc...
- Laws against Trusts and Monopolies
- 5th and 14th Amendments of the U.S. Constitution: no person may be deprived of Life, Liberty, or Property without due process of law.
- 5th Amendment: “just compensation” must be paid to owners when private property is taken for public use.
- *Private property* – property that is owned by individuals or companies, not by the government or the people as a whole.
- Some economic goals are better met in the free market, and some are better met by government action.

DO NOW: In your notes, create a T-chart list of those goals that are better met in the free market, and those that are better met by government action. (30 seconds)

Government Intervention

- Each nation must decide what it is willing to give up to meet its goals.

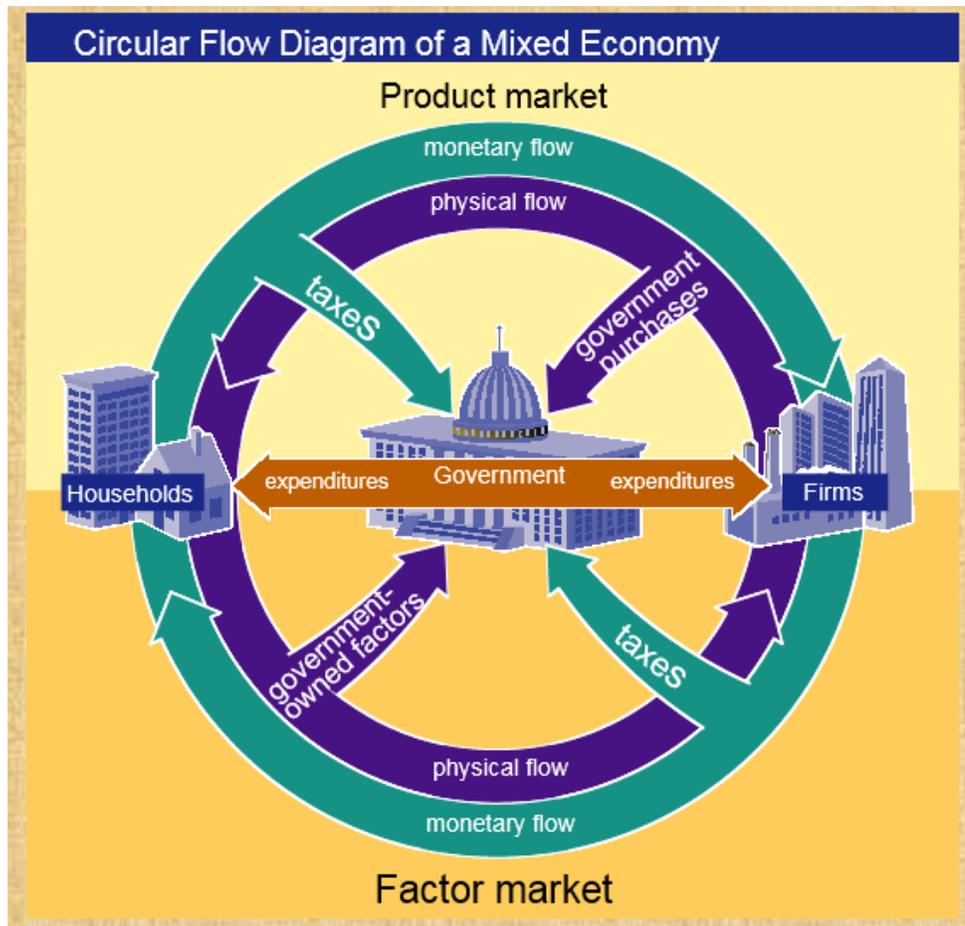
What are you willing to give up?

- Paying private money to fund the army?
- Giving private money to those who do not have a job?
- Paying to fund education for children and teens (or adults)?
- Pay for farmers who have a bad year in crop production?
- To pay for an off-set for a minimum wage?
- To pay for free health-care for all?

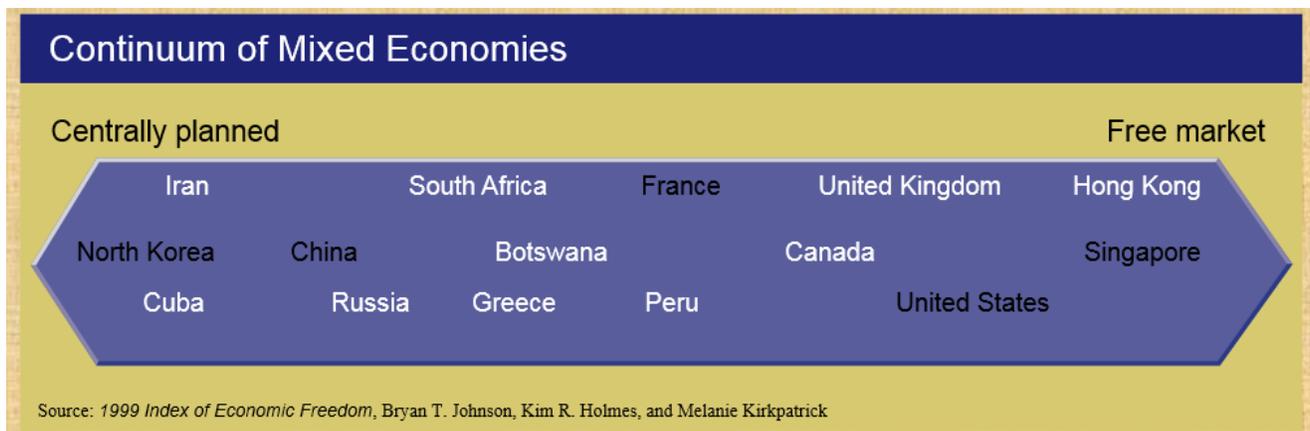
Government Role in a Mixed Economy

1. The government can enter the circular flow of economic activity in a number of ways.
2. Government purchases land, labor, & capital from households
3. Government purchases goods and services in the product market.
4. Government provides certain goods and services through the factor resources they provide.
5. Government collects taxes from both households and businesses.

Transfers the money to other individuals and businesses for a variety of reasons.



An economic system that permits the conduct of business with minimal government intervention is called free enterprise. The degree of government involvement in the economy varies among nations.



Comparing Modern-Day Mixed Economies

Mixed economies where government intervention dominates:

China

- Before 1980, was a command economy

Economy today is still dominated by government, but at least ¼ of all enterprises are owned by individuals.

- Oppressive, one-party government was in charge of the major resources and made all of the economic decisions
- In the 1990s, China began incorporating features of free enterprise to its economic system

China is in *transition* – a period of change in which an economy moves away from central planning toward a market-based system.

State firms must be *privatized* – sold to individuals, and allowed to compete on the market

Comparing Modern-Day Mixed Economies

Mixed Economies where the market system dominates:

United States

- Considered a market/free enterprise system with elements of command – government still “intervenes” to keep order, provide vital services, and to promote the general welfare

People are free to compete and distribute goods and services

Laws protect private property

Our government provides, or “commands” the economy, to provide certain services, such as education, mail services, national defense, airports, highways, etc...

Why are the economies of the world mixed?

- Command Economies:
 1. Became too stagnate
 2. Consumer wants/needs not met
 3. Lack of Civil Rights
- Free Market Economies
 1. The gap between the rich and the poor grew ever larger
 2. The big growing ever bigger (corruption)
 3. The Free Market did not meet all our needs (protection)
- Pure economies simply don't seem to work.