Objectives

1. **Identify** the three key economic questions that all societies must answer.

2. **Analyze** the societal values that determine how a country answers the three economic questions.

3. **Define** the characteristics of a traditional economy.
Key Terms

• **economic system**: the structure of methods and principles that a society uses to produce and distribute goods and services

• **factor payment**: the income people receive in return for supplying factors of production

• **profit**: the amount of money a business receives in excess of expenses

• **safety net**: a set of government programs that protect people who face unfavorable economic conditions
• **standard of living**: level of economic prosperity

• **innovation**: the process of bringing new methods, products, or ideas into use

• **traditional economy**: an economic system that relies on habit, custom, or ritual to decide the three key economic questions
Introduction

• What goals and values affect how a society answers the key economic questions?
  – Each society is guided by its economic system, which affects the way in which it does business within the society itself and with other societies.
  – A society’s values, such as freedom or tradition, guide the type of economic system that society will have.
Three Economic Questions

As a result of scarce resources, societies must answer three key economic questions:

- What goods and services should be produced?
- How should these goods and services be produced?
- Who consumes these goods and services?

How a society answers these three questions defines the type of economic system that society has.
Questions 1 and 2

• What goods and services should be produced?
  – Each society must decide what to produce in order to satisfy the needs and wants of its people.
  – Because resources are limited, each decision that a society makes about what to produce comes at an opportunity cost.

• How should goods and services be produced?
  – As a society decides how to produce its goods and services, it must consider how best to use its land, labor, and capital.
Combining Factor Resources

Hand Tools

1 acre of land + 56 worker-hours + capital = 15 bushels of wheat

Modern Mechanical Equipment

1 acre of land + 2.9 worker-hours + capital = 40 bushels of wheat
Question 3

• Who consumes goods and services?

  – This question is largely determined by how societies distribute income.
  – Through factor payments, including profits, societies can determine who will be the consumers of the goods and services produced.
Economic Efficiency

• Societies answer the three economic questions based on the importance they attach to various economic goals.

• Because resources are always scarce, societies try to maximize what they can produce using the resources they have.
  – If a society can accurately assess what to produce, it increases economic efficiency.
Economic Freedom and Security

• Some societies limit the economic freedoms of its people.
  – In the United States, Americans face some limitations but, in general, we enjoy a large amount of economic freedom.

• Economic systems also strive to achieve a certain degree of economic security.
  – Ideally, economic systems seek to reassure people that goods and services will be available when needed and they can count on receiving expected payments on time.
Economic Equity

• Economic equity is another economic goal that is defined differently in different societies. Each society must decide how to divide its economic pie.

• Checkpoint: What are two examples of economic goals?
Economic Growth

• A society also strives for economic growth. A nation’s economy must grow so it can provide jobs for the new people joining the workforce.
  
  – A nation strives to improve its standards of living.
  – Innovation plays a huge role in economic success as well.
Economic Goals in Conflict

• There are some additional economic goals for certain societies, including environmental protection, full employment, and protecting national industries.

• All societies must prioritize their economic goals, or arrange them in order of importance. Each choice comes with some kind of trade-off.
Traditional Economies

- The oldest and simplest economic system is known as a traditional economy.
  - Traditional economies rely on habit, custom, or ritual and revolve around the family. There is little room for innovation or change.
Traditional Economies, cont.

• Traditional economies are usually found in communities that tend to stay small and close.

  – Often members of these societies work to support the entire community, rather than just themselves or their immediate families.
Traditional Economies, cont.

- Societies with traditional economies are successful if they meet their own needs.
  - In many cases, these communities lack modern conveniences and have a relatively low standard of living.
Chapter 2: Economic Systems
Section 2
Objectives

1. Explain why markets exist.
2. Analyze a circular flow model of a free market economy.
3. Describe the self-regulating nature of the marketplace.
4. Identify the advantages of a free market economy.
**Key Terms**

- **market**: any arrangement that allows buyers and sellers to exchange things
- **specialization**: the concentration of the productive efforts of individuals and businesses on a limited number of activities
- **free market economy**: an economic system in which decisions on the three key economic questions are based on the voluntary exchange in markets
- **household**: a person or group living in a single residence
Key Terms, cont.

- **firm**: an organization that uses resources to produce a product or service, which it then sells
- **factor market**: the arena of exchange in which firms purchase the factors of production from households
- **product market**: the arena of exchange in which households purchase goods and services from firms
- **self-interest**: an individual’s own personal gain
Key Terms, cont.

• **incentive**: the hope of reward or fear of penalty that encourages a person to behave a certain way

• **competition**: the struggle among producers for the dollars of consumers

• **invisible hand**: a term coined by Adam Smith to describe the self-regulating nature of the marketplace

• **consumer sovereignty**: the powers of consumers to decide what gets produced
Introduction

What are the characteristics of a free market economy?

- A free market economy is characterized by:
  - Households and firms
  - Factor and product markets
  - Self-interest
  - Competition
  - Economic freedom, efficiency, and equity
The Purpose of Markets

• Checkpoint: Why do markets exist?
  – Markets, like a farmer’s market, a sporting goods store, and the New York Stock Exchange, eliminate the need for any one person to be self-sufficient.
  – Markets allow us to exchange the things we have for the things we want.
Specialization

• Rather than being self-sufficient, each of us specializes in a few products or services.
  – Specialization leads to efficient use of land, labor, and capital.
  – Specialization allows businesses to focus on a limited number of related products or services.

• Because of specialization, markets are needed to give people an arena with which to sell their products and to buy products that they don’t produce themselves but need.
Free Market Economy

• In a free market, answers to the three key economic questions are made by voluntary exchange in the marketplace.
• Choices made by individuals determine what gets made, how it is made, and how much people can consume of the goods and services produced.
• In a free market system, individuals and privately owned businesses own the factors of production.
Circular Flow Model of a Market Economy

Product Market

Monetary Flow

Physical Flow

Households pay firms for goods and services.

Firms supply households with goods and services.

Firms pay households for land, labor, and capital.

Households supply firms with land, labor, and capital.

Factor Market

Firms
Factor and Product Markets

- In an arena of exchange known as the factor market, firms purchase factors of production, such as renting land, hiring and paying workers, and borrowing money, from households.

- The arena in which households buy the goods and services that firms produce is called the product market.
Self-Regulation

• In *The Wealth of Nations*, Adam Smith observes that in the countless transactions that occur in the market, the buyer and seller consider only their self-interest.

  – Self-interest is the motivating force in the free market.
  – Consumers pursuing their self-interest have the incentive to look for lower prices.
Self-Regulation, cont.

- According to Smith, consumers will respond to the positive incentive of lower prices by buying more goods because spending less money on a good lowers the opportunity cost of the purchase.
What are Incentives?

Positive Incentive

• Higher grades make it easier for Andre to get into a good college.
• Andre’s parents promise him concert tickets if he improves his grades.

Negative Incentive

Andre’s parents threaten to ground him if his grades continue to slump.

Response

Andre spends more time studying.

Positive Incentive

State government offers tax credit for commuters who use public transportation.

Negative Incentive

State raises gasoline taxes.

Response

Gas consumption drops as many workers take the bus rather than drive.
• Checkpoint: Why is competition important to the free market?
  – Firms seek to make higher profits by increasing sales.
  – Because of competition among other firms, however, increasing sales is not always possible.
  – Self-interest and competition work together to regulate the marketplace.
  – Smith called this self-regulating mechanism of the market “the invisible hand.”
Advantages of a Free Market

• Under ideal conditions, free market economies meet the following economic goals:
  – They respond to rapidly changing conditions.
  – They have a large degree of economic freedom.
  – They encourage economic growth.
  – They lend themselves to consumer sovereignty.

What free market principle does this cartoon illustrate?
Advantages, cont.

- Despite the advantages of a free market economy, no country today operates under a pure, unregulated free market.
Chapter 2: Economic Systems
Section 3
Objectives

1. **Describe** how a centrally planned economy is organized.

2. **Distinguish** between socialism and communism.

3. **Analyze** the use of central planning in the Soviet Union and China.

4. **Identify** the disadvantages of a centrally planned economy.
Key Terms

• centrally planned economy: an economic system in which the government makes all decisions on the three key economic questions

• command economy: another name for a centrally planned economy

• socialism: a range of economic and political systems based on the belief that wealth should be distributed evenly throughout society
Key Terms, cont.

- **communism**: a political system in which the government owns and controls all resources and means of production and makes all economic decisions.

- **authoritarian**: describing a form of government which limits individual freedoms and requires strict obedience from their citizens.
Introduction

• What are the characteristics of a centrally planned economy?

  – A centrally planned economy is characterized by:
    • Government answering the three economic questions
    • Government ownership of land, labor, and capital
    • Opposition to private property, free market pricing, competition, and consumer choice
How Central Planning Works

• Checkpoint: Who makes key decisions in a centrally planned economy?

  – In a centrally planned economy (also known as a command economy), the government, rather than individual producers and consumers, answer the key economic questions.
    • The government owns both land and capital.
    • The government also controls where people work and what they are paid.
Command v. Free Market

- Command economies operate in direct contrast to free market systems.

- Command economies oppose:
  - Private property
  - Free market pricing
  - Competition
  - Consumer choice
Socialism

• The term socialism describes a range of economic and political systems based on the belief that wealth should be evenly distributed throughout society.

• Socialists argue that economic equity can only exist if the centers of economic power are controlled by the government or by the public as a whole, rather than by individuals or corporations.
Market Socialism

• In some nations, like Sweden, socialism coexists with free market practices.

• This is known as “market socialism.”
  – Under this system the government uses its powers of taxation to redistribute wealth and provide extensive services.
Communism

• Checkpoint: What beliefs did Karl Marx hold about capitalism?

– Under communism, the central government owns and controls all resources and means of production.
  • Communism derived from the writings of Karl Marx who believed that labor was the source of all value but that under capitalism, all the profit created by laborers ended up in the hands of the property owners.
  • The inevitable cost of capitalism according to Marx was the exploitation of workers and an unfair distribution of wealth.
The Soviet Union

- The Soviet Union became the world’s first communist state in 1917 and remained so until it broke up in 1991.

  - Soviet economic planners sought to build power and prestige and allocated the best land, labor, and capital to heavy industry.
  - This decision had a harsh effect on factories that made consumer goods.
The Soviet Union, cont.

- Shortages were a recurring problem in the Soviet Union. Consumers would often wait in long lines at stores, only to discover that there was nothing to buy.
China

- Government planners controlled every aspect of the Chinese economy from 1949 until the late 1970s.
  - The government initially tried to keep some of the farmland private but by the 1950s, the government forced many peasants onto farming communities.
  - This caused farm production to drop sharply.
  - Facing shortages, the government eased its control over the communes.
China, cont.

• By the 1970s, China gave more farmland to private owners.

• Today, China allows more economic freedom than in the past, which has given China’s economy a huge boost.
Disadvantages

- Nations with command economies often have trouble meeting the basic economic goals.
  - The complex bureaucracy of a command economy is not efficiently run and does not adjust quickly to market changes.
  - There is minimal, if any, economic freedom.
  - Innovation is not rewarded and thus economic growth is stilted.
  - There is no economic equity.

- However, command economies do guarantee jobs and income and can be used to jump-start selected industries.
Chapter 2: Economic Systems
Section 4
Objectives

1. Explain the rise of mixed economic systems.
2. Interpret a circular flow model of a mixed economy.
3. Compare the mixed economies of various nations along a continuum between centrally planned and free market systems.
4. Describe the role of free enterprise in the United States economy.
Key Terms

• **laissez faire**: the doctrine that government generally should not intervene in the marketplace

• **private property**: property that is owned by individuals or companies, not by the government or people as a whole

• **mixed economy**: a market-based economic system in which the government is involved to some extent
Key Terms, cont.

- **economic transition**: a period of change in which a nation moves from one economic system to another
- **privatization**: the process of selling businesses or services operated by the government to individual investors, and then allowing them to compete in the marketplace
- **free enterprise system**: an economic system in which investments in firms are made in a free market by private decision rather than by state control
Introduction

• What are the characteristics of a mixed economy?

  – A mixed economy is characterized by:
    • A market-based economy with some government intervention
    • Government helps societies meet needs that would be too difficult for them to meet under a totally free market economy, such as education
    • Government protects property rights and ensures that exchanges in the marketplace are fair
The Rise of Free Markets

• Even free market thinkers like Adam Smith recognized the need for a limited degree of government involvement in the economic marketplace.

• In a mixed economy, the market is free but has a certain degree of government control.
The Rise of Free Markets, cont.

– Checkpoint: What is one reason the government plays a role in the economy?
– The government:
  • Provides national defense and public education
  • Protects private property
  • Ensures fair exchanges in the marketplace
Circular Flow Model of a Mixed Economy

Product Market

Monetary Flow

Physical Flow

Taxes

Government Purchases

Expenditures

Government

Firms

Households

Factor Market

Government Owned Factors

Taxes

Physical Flow

Monetary Flow
Government in the Market

• Governments buy labor in the factor market to have employees help run its programs.
• Governments purchase goods and services from firms in the product market.
• Governments also collect taxes from both households and firms.

– Checkpoint: How are governments involved in the product market?
Comparing Mixed Economies

- Most modern economies are mixed economies.
  - The figure below shows a continuum of mixed economics in today’s world.
  - Why is China a little bit farther to the right on the diagram below than Cuba?
North Korea and China

• North Korea represents one extreme of the continuum.
  – North Korea’s economy is almost totally dominated by the government. The government owns all the property and output equipment.

• China, on the other hand, is closer to the center of the continuum because China is going through an economic transition toward privatization of state-owned firms.
Hong Kong

- Hong Kong represents one of the world’s freest markets.
  - In Hong Kong, the private sector rules.
  - The government protects private property and rarely interferes in the free market, aside from establishing wage and price controls on rent and some public services.
The United States

- The United States is a mixed economy whose foundation is the free market.

- It is characterized as a free enterprise system.
Government Intervention

• The American government intervenes in the economy by:
  – Keeping order
  – Providing vital services
  – Promoting general welfare

• Federal and state laws protect private property.
  – The marketplace operates with a limited degree of government regulation.
American Economic Freedom

• The United States enjoys a high level of economic freedom.
  – Foreign investment and free trade is encouraged
  – The banking industry operates under relatively few restrictions
  – Foreign-owned banks have few additional restrictions