

Answering the Three Economic Questions

Preview

Objectives

After studying this section you will be able to:

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

Section Focus

All societies must answer three key economic questions about the production and consumption of goods and services. How a society answers these questions depends on how much it values different economic goals. Four different economic systems have developed in response to these three questions.

Key Terms

- economic system
- factor payments
- patriotism
- safety net
- standard of living
- traditional economy
- market economy
- centrally planned economy
- command economy
- mixed economy

In Chapter 1, you read about the economic concept of scarcity—that we cannot have all that we want or need. Indeed, in some places in the world, people cannot even meet their basic needs for food, clothing, and shelter because their resources are too scarce. Scarcity forces societies and nations to answer some hard economic questions. Different economic systems have evolved in response to the problem of scarcity. An **economic system** is the method used by a society to produce and distribute goods and services. Which economic system a society employs depends on that society's goals and values.

Three Key Economic Questions

Because economic resources are limited, every society 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?

What Goods and Services Should Be Produced?

Individuals in every society must decide what to produce in order to satisfy society's needs and wants. In today's complex societies, it is often difficult to distinguish between needs and wants. While it may be obvious that we need food and shelter, modern societies face additional important considerations. How much of our resources should we devote to national defense, education, public health and welfare, or consumer goods? Which consumer goods should we produce?

Recall the guns-and-butter trade-off described in Chapter 1. Because of our limited resources, each production decision that a society makes comes at an opportunity cost.

How Should Goods and Services Be Produced?

The next question we face is how to use our resources to produce goods and services. For example, should we produce electricity with oil, solar power, or nuclear power? Should teachers have classes of 20 students or 50 students? Should we produce food on large corporate farms or on small family farms?

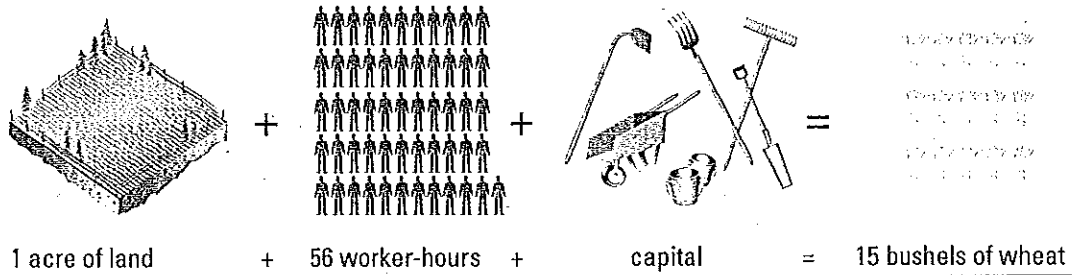
economic system the method used by a society to produce and distribute goods and services



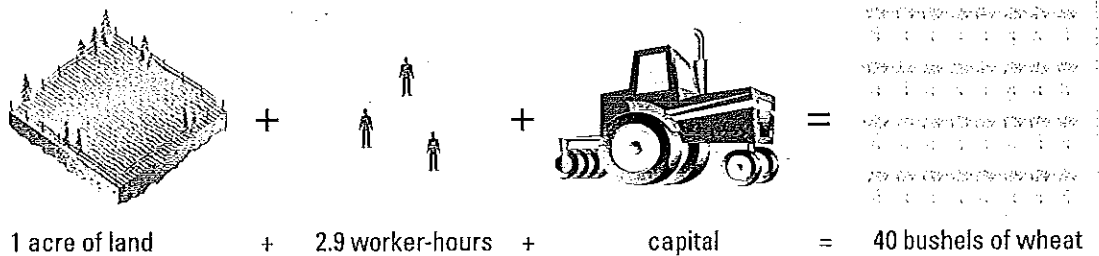
Today, capital—not labor—dominates the answer to how wheat is produced. Opportunity Cost Identify the opportunity costs of each method of farming.

Figure 2.1 Combining Factor Resources

Hand tools



Modern mechanical equipment



factor payments the income people receive for supplying factors of production, such as land, labor, or capital

Although there are countless ways to create all of the things we want and need, all require land, labor, and capital. These factors of production can be combined in different ways. For example, examine the chart above (Figure 2.1). Before the introduction of modern farming equipment, a typical combination of resources for producing 15 bushels of wheat was 56 hours of labor, 1 acre of land, and simple hand tools. With today's mechanical farming equipment, farming is much more efficient. Forty bushels of wheat can be harvested from one acre of land with just 2.9 worker-hours of labor.

Who Consumes Goods and Services?

By the end of the 1990s, the top 25 goods manufacturers in the United States were launching an average of 13 new products every day. Retail stores, which 50 years ago typically carried about 3,000 items, now offered about 30,000 different products. American farms produce 315 million metric tons of wheat, rice, and corn and maintain about 180 million head of livestock. Despite this staggering output, quantities are not unlimited.

How does this abundance get divided up? Who gets to drive a new luxury car and who can only afford a subway pass? Who attends a concert and who stays home? Who eats a well-balanced diet and who eats nothing but hot dogs for every meal? Who gets access to a good education? Societies must decide how to distribute the available goods and services.

The answer to the question of distribution is determined by how societies choose to distribute income. Factor payments are the income people receive for supplying factors of production—land, labor, capital, or entrepreneurship. Landowners receive rent, workers receive wages, and those who lend money to build factories or buy machinery receive payments called interest. Entrepreneurs earn profits if their enterprises succeed.

How much should we pay the owners of the factors of production? How do we decide how much a particular piece of land is worth, how much teachers should earn versus how much doctors should earn, or what the interest rate should be?

The question of who gets to consume which goods and services lies at the very

heart of the differences between economic systems today. Each society answers the question of distribution based on its unique combination of social values and goals.

Economic Goals and Societal Values

Different societies answer the three economic questions based on the importance they attach to various economic goals. Figure 2.2 lists some general economic goals that most economic systems try to address. Bear in mind that societies pursue each of these goals, to some degree, at the expense of the others.

Economic Efficiency

Because resources are always scarce—that is, they always involve an opportunity cost—most societies try to maximize what they can get for the resources they have to work with. If a society can accurately assess what to produce, it increases its economic efficiency. A manufacturer would be wasting resources producing record albums if people prefer to buy CDs. Knowing the best way to produce a product cuts waste, too. Of course, in the end, products need to reach consumers. An economy that can't deliver goods isn't efficient.

Economic Freedom

Most of us value the opportunity to make our own choices. How do you feel about laws that keep you from earning an income? What about laws that forbid you to make certain purchases or possess certain items? The economic systems of different nations allow different degrees of economic freedoms. In general, however, people all over the world face limitations on economic freedom.

In the United States, the economic freedoms that we as Americans enjoy are an important reason for our patriotism. **Patriotism** is the love of one's country—the passion that inspires a person to serve his or her country, either in defending it from invasion or protecting its rights and maintaining its laws and institutions. The freedoms that allow any American who so chooses to become an entrepreneur, for example, are continuing sources of pride and patriotism.

Economic Security and Predictability

Most people don't like uncertainty. We want to know that we can get milk and bread every time we go to the grocery store, or that the gas pumps will be full when we

patriotism the love of one's country; the passion that inspires a person to serve his or her country



This family (left) will need to rebuild their home after a devastating hurricane. Government Which economic goal could help them recover from the storm?



Figure 2.2 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.

safety net government programs that protect people experiencing unfavorable economic conditions

standard of living level of economic prosperity

traditional economy economic system that relies on habit, custom, or ritual to decide questions of production and consumption of goods and services

▼ **The traditional economy of Guatemala's Quiché Maya includes regular market days.**

go to gas up our cars. We want to feel confident that we will get our paychecks every payday. Ideally, economic systems reassure people that goods and services will be available when they need them and that they can count on receiving expected payments on time.

We also want the security of knowing that help is available if we are elderly, poor, unemployed, or facing some other potential economic disadvantage. Most people feel that the government should provide some kind of **safety net**, or set of government programs that protect people experiencing unfavorable economic conditions. These include injuries, layoffs, natural disasters, or severe shortages. Many countries also provide some sort of base income for retired persons to ensure that older people can support themselves after retirement.

Economic Equity

Each society must decide the best way to divide its economic pie. What constitutes a fair share? Should everyone get the same, or should one's consumption depend on how much one produces? How much should society provide for those who are unable or unwilling to produce?

Many people believe in equal pay for equal work, but society does not value all jobs equally. Most lawyers earn more than most nurses. Most computer programmers

earn more than most truck drivers. Not everyone is able to work. How should we provide for the ill and infirm?

Economic Growth and Innovation

A nation's economy must grow for a nation to improve its **standard of living**, or level of economic prosperity. This is especially true if a country's population is growing. The economy also must grow to provide new jobs and income for people.

Innovation plays a huge role in economic growth. Think of the changes brought about by the shift from nomadism to agriculture, from the agricultural age to the industrial age, from the industrial age to the information age. Innovations in technology increase the efficiency of production and usher in new goods and services. In your lifetime, you are witnessing innovations in computer and networking technology that are changing the ways people work, shop, conduct business, locate information, and communicate.

Additional Goals

A society may value goals in addition to those described above. Environmental protection, full employment, universal medical care, and other important concerns may be among a nation's chief economic goals.

All nations must prioritize their economic goals, or arrange them in order of importance. No matter how a nation prioritizes its goals, one fact remains: achieving any economic goal comes only with some kind of economic trade-off.

Economies and Values

Four different economic systems have developed to address the three key economic questions. Each system reflects a different prioritization of economic goals. It also reflects the values of the societies in which these systems are present.

Traditional Economies

A **traditional economy** relies on habit, custom, or ritual to decide what to



produce, how to produce it, and to whom to distribute it. There is little room for innovation or change. The traditional economic system revolves around the family. Work tends to be divided along gender lines. Boys tend to take up the occupations of their fathers, while girls follow in the footsteps of their mothers.

Traditional economies are usually communities that tend to stay relatively small and close. Often these societies work to support entire groups, rather than just themselves or their immediate families. Agricultural and hunting practices usually lie at the very heart of the people's lives, laws, and religious beliefs.

Societies with traditional economies have few mechanisms in place to deal effectively with the effects of environmental disaster, such as a flood or drought. They also tend to remain stagnant, resisting change at both the individual and community level. They may be slow to adopt new technology or radical new ideas. They may not have access to goods you see every day at the grocery store. In most cases, these communities lack modern conveniences and have a low standard of living.

Market Economies

In a **market economy**, economic decisions are made by individuals and are based on exchange, or trade. The choices made by individuals determine what gets made and how, as well as who consumes the goods and services produced. Market economies are also called free markets, or capitalism. You will read about the free market in detail in Section 2.

Command Economies

In a **centrally planned economy**, the central government alone decides how to answer all three key economic questions. Centrally planned economies are sometimes called **command economies**, because a central authority is in command of the economy. Section 3 discusses the theories behind centrally planned economies.

Mixed Economies

Most modern economies are **mixed economies**—market-based economic systems in which government plays a limited role. Section 4 describes the reasons for mixed economies and the various ways government is involved in such economies.

market economy
economic system in which decisions on production and consumption of goods and services are based on voluntary exchange in markets

centrally planned economy
economic system in which the central government makes all decisions on the production and consumption of goods and services

command economy
economic system in which a central authority is in command of the economy; a centrally planned economy

mixed economy
market-based economic system with limited government involvement

Section 1 Assessment

Key Terms and Main Ideas

1. What is an **economic system**?
2. How do a **traditional economy**, a **market economy**, a **command economy**, and a **mixed economy** differ?
3. Why aren't all people paid the same amount in **factor payments** for the resources they provide? Provide your own example of two unequal factor payments.
4. Why do governments provide **safety nets** for their citizens?
5. Give at least one example of a traditional, a command, and a market economic system.

Applying Economic Concepts

6. **Using the Databank** Examine the graph "Government Spending, by Category" on page 543. Based on the information in the graph, identify what you think are some economic goals of the United States.
7. **Critical Thinking** Create a chart in which you list the societal values of each of the four economic systems described in the section.
8. **Try This** You and your friends decide to earn money by washing cars. How are the three economic questions answered in this market?



Take It to the NET

Companies answer the three basic economic questions all the time. A company's "mission statement" usually contains the answers to most of these questions. Find a company you already are familiar with, and then identify its mission statement and how it does or does not answer the three basic questions. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. www.phschool.com

The Free Market

Preview

Objectives

After studying this section you will be able to:

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

Section Focus

Markets exist so that people can exchange what they have for what they want. A free market is a self-regulating economic system directed by individuals acting in their own self-interest.

Key Terms

market	self-interest
specialization	incentive
household	competition
firm	invisible hand
factor market	consumer
profit	sovereignty
product market	

market an arrangement that allows buyers and sellers to exchange things

What do a farmers' market, a sporting goods store, the New York Stock Exchange, and the sign you posted on your community bulletin board advertising baby-sitting services have in common? All are examples of markets. A **market** is an arrangement that allows buyers and sellers to exchange things.

Why Markets Exist

Markets exist because no one is self-sufficient. In other words, none of us produces all we require to satisfy our needs and wants. You probably didn't grow the plants to make the fibers to weave the cloth to make the shirt you're wearing. Instead, you purchased your shirt at a store, which is an example of a market. Markets allow us to exchange the things we have for the things we want.

Specialization

Instead of being self-sufficient, each of us produces just one or a few products. A nurse specializes in caring for the sick. A



► This Thai spice stand, Brazilian stock exchange, and Indian barber shop (left to right) are all examples of markets.

marine mechanic specializes in repairing machinery aboard sea craft. A baker specializes in making breads, cakes, and cookies. **Specialization** is the concentration of the productive efforts of individuals and firms on a limited number of activities.

Specialization makes us more efficient. It is much easier to learn one task or a few tasks very well than to learn them all.

Buying and Selling

Because each of us specializes in producing just a few products, we need markets to sell what we have and to buy what we want. The typical person earns an income (specializing at a particular job) and uses this income to buy the products that he or she wants to consume. If each person were self-sufficient, producing everything he or she wanted to consume, there would be no need for markets.

Free Market Economy

Economic systems that are based on voluntary exchanges in markets are called free market economies. In a free market economy, individuals and businesses use markets to exchange money and products.

In a free market system, individuals and privately owned businesses own the factors of production, make what they want, and buy what they want. In other words, in a free market system, individuals answer the three key economic questions of what to

produce, how to produce it, and who consumes that which is produced. As you might guess, a free-market economy functions best in an environment of decentralized decision-making such as enjoyed in the United States.

We can represent a free market economy in a special kind of drawing called a circular flow diagram, or model. A circular flow diagram shows at a glance how individuals and businesses exchange money, resources, and products in the marketplace. Figure 2.3 shows a circular flow diagram of a free market economy. The inner ring of the diagram represents the flow of resources and products. The outer ring represents the flow of money.

Households and Firms

The players in the free market economy are households and firms. A **household** is a person or group of people living in the same residence. Households own the factors of production—land, labor, and capital. Households are also the consumers of goods and services.

A business, or **firm**, is an organization that uses resources to produce a product, which it then sells. Firms transform “inputs,” or factors of production, into “outputs,” or products.

Factor Market

As you can see from the lower half of the circular flow diagram in Figure 2.3, firms purchase factors of production from households. This arena of exchange is called the **factor market**. Firms purchase or rent land (natural resources). They hire workers, paying them wages or salaries for their labor. They also borrow money from households to purchase capital, paying households interest or profits in return. **Profit** is the financial gain made in a transaction.

Product Market

Take a close look at the top half of the circular flow diagram in

specialization the concentration of the productive efforts of individuals and firms on a limited number of activities

household a person or group of people living in the same residence

firm an organization that uses resources to produce a product, which it then sells

factor market market in which firms purchase the factors of production from households

profit the financial gain made in a transaction

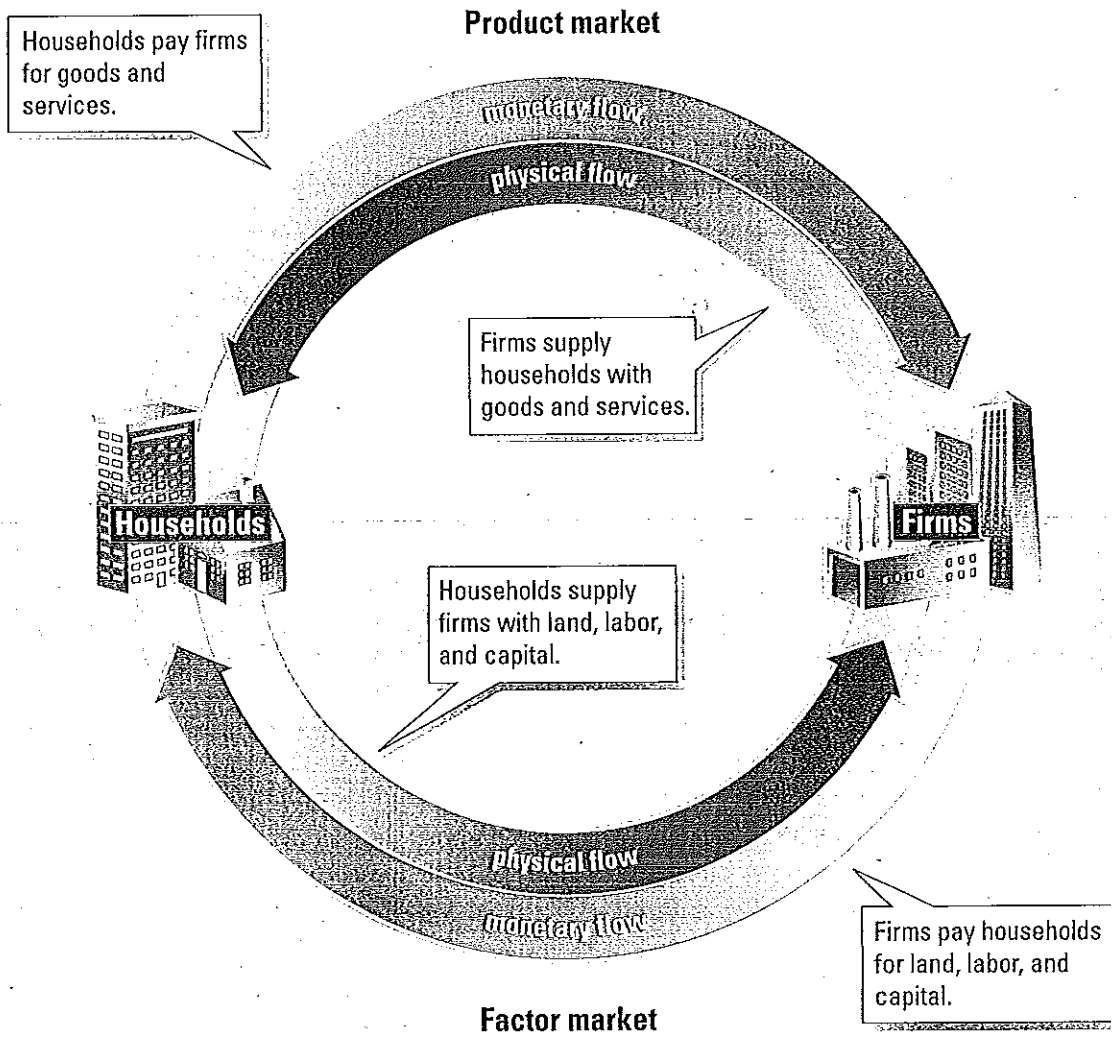




A circular flow model shows the interactions between households and businesses in the free market.

Economic Systems
What is exchanged in the factor market? In the product market?

Figure 2.3 Circular Flow Model of a Market Economy



product market
the market in which households purchase the goods and services that firms produce

Figure 2.3. You can see that the goods and services that firms produce are purchased by households in the **product market**.

If you follow the rings of the diagram, you will see that households purchase the products made by firms with the money they received from firms in the factor market. The flow between the factor market and the product market is truly circular.

The Self-Regulating Nature of the Marketplace

How is it that firms and households cooperate to give each other what they want—factor resources, in the case of firms, and

products, in the case of households? As anyone knows who has tried out for the track team, a part in a play, or has applied for a job or to a college, we live in a competitive society. According to Adam Smith, it is, in fact, competition and our own self-interest that keep the marketplace functioning.

Self-Interest

Adam Smith was a Scottish social philosopher who, in 1776, published a book titled *The Wealth of Nations*, in which he described how the market functions. Smith observed that an economy is made up of countless individual transactions. In each transaction, the buyer and seller consider

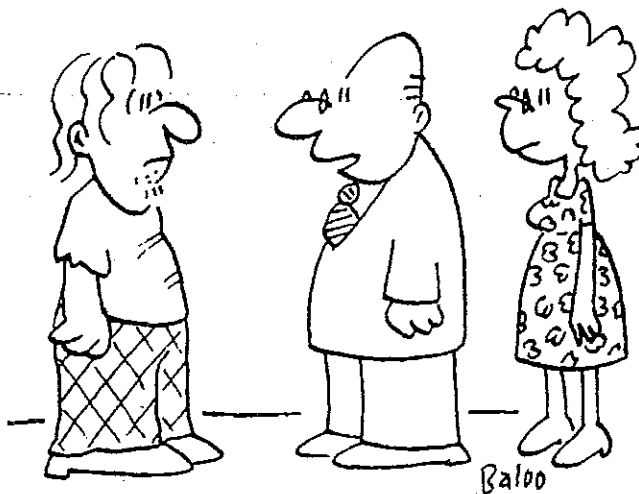
only their **self-interest**, or their own personal gain. Self-interest, in other words, is the motivating force in the free market.

Competition

Consumers (households), in pursuit of their self-interest, have the incentive to look for lower prices. An **incentive** is the hope of reward or the fear of punishment that encourages a person to behave in a certain way. Adam Smith observed that people respond predictably to both positive and negative incentives. As for consumers, we can predict that they will respond to the positive incentive of lower prices. This makes sense, because spending less money on a good lowers the opportunity cost of the purchase.

Firms, meanwhile, seek to make greater profits by increasing sales. Let's take, for example, a shirt manufacturer. The manufacturer produces and sells polka-dotted shirts and striped shirts. The striped shirts are far outselling the polka-dotted shirts. The manufacturer has the incentive—from more potential sales and profits—to produce more striped shirts. Other manufacturers, observing consumers' desire for striped shirts, also have the incentive to sell striped shirts. With all these manufacturers in the market, consumers have all the striped shirts they want.

Manufacturers also have a second incentive—to make the most profit in selling striped shirts. What keeps manufacturers' pursuit of profit from causing prices to



"Son, your mother and I have decided to let the free market take care of you."

skyrocket? If one manufacturer begins charging \$30.00 for a striped shirt, another manufacturer can come along and sell striped shirts for \$25.00. If the first manufacturer wants to sell any more striped shirts, he or she had better drop the selling price. Consumers, pursuing their self-interest, will buy the lower-priced shirt. Economists call this struggle among producers for the dollars of consumers **competition**. While self-interest is the motivating force behind the free market, competition is the regulating force.

The Invisible Hand

Self-interest and competition work together to regulate the marketplace. Self-interest spurs consumers to purchase certain goods

▲ How could the free market take care of this young man?

self-interest one's own personal gain

incentive an expectation that encourages people to behave in a certain way

competition the struggle among producers for the dollars of consumers



◀ Competing businesses scream for the attention of consumers.

FAST FACT

Self-interest and the free market will provide social services—if there's a profit to be gained. One large temporary employee agency recruits and trains workers from the ranks of the urban poor. Bypassing the social-welfare agencies that are charged with getting people off public assistance, it finds work for individuals and employees for businesses, and makes a profit for itself.

and services and firms to produce them. Competition causes more production and moderates firms' quests for higher prices. The overall result is that consumers get the products they want at prices that closely reflect the cost of producing them. All of this happens without any central plan or direction. Adam Smith called this phenomenon "the invisible hand of the marketplace."

economic freedom of any system. This includes 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* Because competition encourages innovation, free markets encourage growth. Entrepreneurs are always seeking profitable opportunities, contributing new ideas and innovations.
4. *Additional goals* Free markets offer a wider variety of goods and services than any other system, because producers have incentives to meet consumers' desires. Consumers, in essence, decide what gets produced. This is called **consumer sovereignty**.

Advantages of the Free Market

Competition and the pursuit of self-interest serve the public interest. The free market, on its own, meets many economic goals.

1. *Economic efficiency* Because it is self-regulating, a free market economy responds efficiently to rapidly changing conditions. Producers make only what consumers want, when they want it, and generally at prices they are willing to pay.
2. *Economic freedom* Free market economies have the highest degree of

Despite its advantages, no pure market economy exists on any meaningful scale. The same features that make free markets attractive also represent the weaknesses of the free market. The goals of economic equity and economic security are difficult to achieve in a pure market system. In Section 4, you will read about how the free market system has been modified by various nations in order to better meet the entire array of economic goals.

invisible hand term
economists use to describe the self-regulating nature of the marketplace

consumer sovereignty
the power of consumers to decide what gets produced

Section 2 Assessment

Key Terms and Main Ideas

1. How does **specialization** make us more efficient?
2. What is the difference between the **factor market** and the **product market**?
3. What is **profit**?
4. What are the roles of **households** and **firms** in a market economy?
5. How does **competition** among firms benefit consumers?
6. Explain what Adam Smith meant by "the **invisible hand** of the marketplace."
7. What is the connection between **incentives** and **consumer sovereignty** in a free market economy?

Applying Economic Concepts

8. *Critical Thinking* Why is economic equity difficult to achieve in a free market economy?
9. *Try This* You will need a stack of paper and two staplers. You and a friend create "fold-its" by folding each sheet of paper in thirds and stapling both ends. How many fold-its can you make in two minutes? Next, try special-izing: one of you folds while the other staples. Now how many fold-its can you make in two minutes?
10. *Critical Thinking* Provide at least three real-world examples to illustrate the circular flow model of a market economy.



Take It to the NET

A high degree of economic freedom is a characteristic of a free market system. Which countries exhibit the most economic freedom? Where are most of these countries located? Use the links provided in the Social Studies area at the following Web site for help in completing this activity. www.phschool.com

Profile

Adam Smith (1723–1790)

One of the first people to offer an explanation of how a market economy works was the Scottish philosopher Adam Smith.

Beginning in his early twenties, Smith enjoyed a long career teaching at universities in Scotland. Although more than a little absent-minded, Smith was adored by his students and respected by his fellow professors. More importantly, his ideas won him fame and influence across Britain.



The Wealth of Nations

Today, we most remember Adam Smith for the theories expressed in his book *The Wealth of Nations*. Published in 1776, *The Wealth of Nations* still stands as an authoritative description of how a market system can flourish.

In the book, Smith identifies land, labor, and capital as the factors of production that generate a nation's wealth. When the production of goods is divided into many steps, and workers specialize in only one step, productivity increases. Higher productivity increases the overall wealth of the nation.

Laissez Faire

Adam Smith also called for restricting the role of government in the economy. Smith insisted that government must leave individuals as free as possible to pursue their own interests if a market economy is to run smoothly. This policy is known as *laissez faire*, which means "let them do (as they please)." In Smith's view, individuals left alone to try to better themselves will produce a multiplication of riches: more jobs and more goods and services.

The Invisible Hand and Self-Interest

Adam Smith also noticed that businesses could provide the goods and services that consumers needed without the help of a central plan telling them what to do. How do they do it? Smith gave credit to an invisible hand.

In Smith's view, the invisible hand guides a nation's resources to their most productive use. One of the invisible hand's tools is self-interest. Individuals, each pursuing what is best for him or her, make decisions that ultimately benefit the nation.

For example, consumers can satisfy their self-interest by buying goods. Business people satisfy their self-interest by making the goods consumers want and selling them for a profit. As sales increase, businesses can raise prices. At this point the invisible hand takes over. Another person sees the profits and starts a competing business, charging a slightly lower price. Other businesses must follow if they want to keep their customers, and balance is restored to the market.

CHECK FOR UNDERSTANDING

1. Source Reading Rewrite the following passage from *The Wealth of Nations* in your own words: "It is not from the benevolence [kindness] of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."

2. Critical Thinking What are the forces that together comprise the invisible hand?

3. Learn More Conduct further research and describe the similarities between two 1776 publications: *The Wealth of Nations* and the Declaration of Independence.

Centrally Planned Economies

Preview

Objectives

After studying this section you will be able to:

1. Describe how a centrally planned economy is organized.
2. Analyze the centrally planned economy of the former Soviet Union.
3. Identify the problems of a centrally planned economy.

Section Focus

In a centrally planned, or command economy, the central government controls the economy. Central planning has limitations and disadvantages not found in market economies.

Key Terms

socialism
communism
authoritarian
collective
heavy industry

Centrally planned economies operate in direct contrast to free market systems. Centrally planned economies "oppose private property, free market pricing, competition, and consumer choice.

How Is a Centrally Planned Economy Organized?

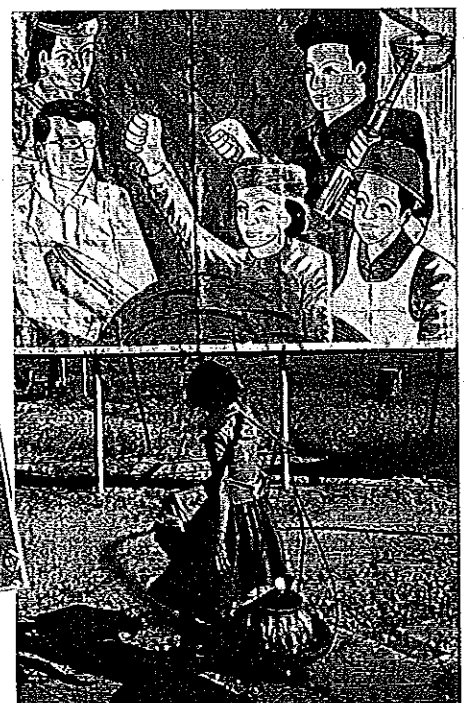
In a centrally planned economy, the central government, rather than individual producers and consumers in markets,

answers the key economic questions of production and consumption. A central bureaucracy makes all the decisions about what items to produce, how to produce them, and who gets them. After collecting information, bureaucrats tell each firm what and how much to produce. It is up to the bureaucrats to ensure that each firm has enough raw materials and workers to meet its production goals.

Government Control of Factor Resources and Production

In a centrally planned economy, the government owns both land and capital. In a sense it owns labor, too, by controlling

► Government posters in Cuba (left) and Cambodia (right) try to inspire worker productivity in these centrally planned economies.



where individuals work and what wages they are paid. The government decides what to produce, how much to produce, and how much to charge. Each year, it directs workers to produce a certain number of trucks, so many yards of cotton fabric, a certain amount of glass, and so on. Farmers are told what to plant, how to plant, and where to send their crops. The free market forces of self-interest and competition are absent from the system.

For example, let's follow the decision-making process for the production of military uniforms and a consumer product—sweaters.

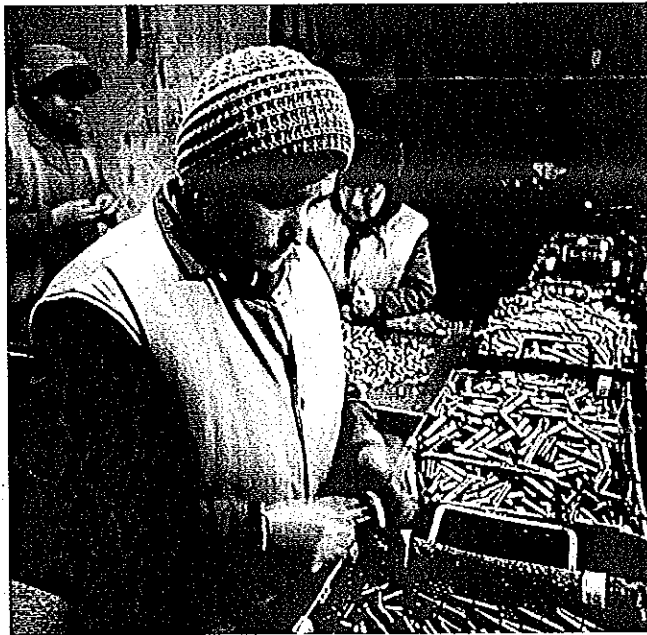
1. The top planners decide that more military uniforms than sweaters will be made. They send this decision to the materials committee.
2. Knowing how much cotton is available, the materials committee decides how many sweaters and how many military uniforms will be made. They send their decision to the cotton makers, the button makers, and the elastic makers.
3. The cotton, the buttons, and the elastic arrive at sweater factories and uniform factories where they are manufactured into sweaters and uniforms.

As you can see, decisions on what to produce and how much to produce are not determined by consumers. Chances are that many citizens living under this economy would still need new sweaters. This lack of consumer voice in production and distribution shows that under centrally planned economies, consumers do not have consumer sovereignty.

Socialism and Communism

The words most often associated with centrally planned economies are *socialism* and *communism*. They are often used interchangeably, but we need to make a distinction between the two terms.

Socialism is a social and political philosophy based on the belief that democratic means should be used to distribute wealth evenly throughout a society. Real equality, socialists argue, can only exist when



▲ How would you describe production in this Romanian factory?

political equality is coupled with economic equality. Economic equality is possible only if the public controls the centers of economic power. Although socialist nations may be democracies, socialism requires a high degree of central planning to achieve economic equality.

In socialist countries the government often owns major industries, such as utilities. Socialism, as you will see in Section 4, exists to varying degrees in different nations throughout the world.

Communism is a political system that arose out of the philosophy of socialism. **Communism** is characterized by a centrally planned economy with all economic and political power resting in the hands of the central government.

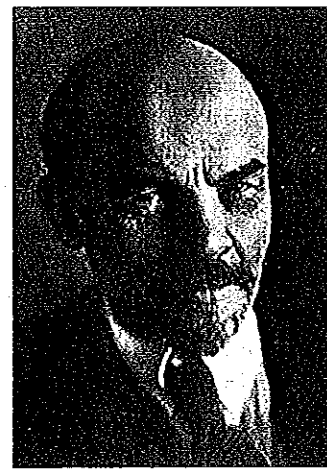
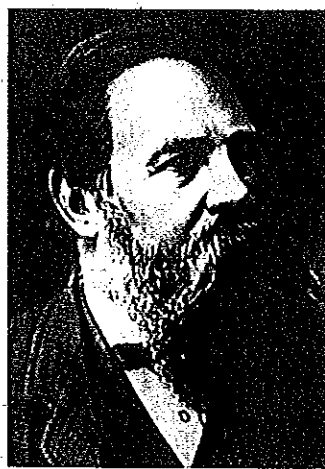
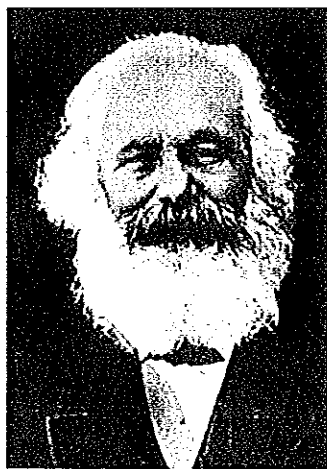
Unlike socialists, however, communists believed that a socialist society can only come about after a violent revolution. While socialist economies can still allow for democracy, communist governments are **authoritarian**. Authoritarian governments exact strict obedience from their citizens and do not allow individuals freedom of judgment and action. Throughout history, communist nations have been dominated by a single political

socialism a social and political philosophy based on the belief that democratic means should be used to evenly distribute wealth throughout a society

communism a political system characterized by a centrally planned economy with all economic and political power resting in the hands of the central government

authoritarian requiring strict obedience to an authority, such as a dictator

► Karl Marx (left) and Friedrich Engels (center) introduced their socialist philosophy in *The Communist Manifesto* in 1848. The term *communist* was adopted by the Bolsheviks who, led by Vladimir Lenin (right), took control of Russia in 1917.



collective large farm leased from the state to groups of peasant farmers

party or dictator. The former Soviet Union was a communist nation that provides us with a good case study of how a centrally planned economy works—and doesn't work.

The Former Soviet Union

The Soviet Union arose out of a pair of revolutions in Russia in 1917. In March, imperial rule in Russia came to an end when Czar Nicholas II was forced from the throne. A provisional republican government was set up, but by November it, too, was toppled. It was taken over by the Bolsheviks, revolutionary socialists led by Vladimir Lenin. Once in power, they renamed themselves communists, instituted a reign of terror, and murdered the former czar and his wife and children. Under the control of the Communist party, central planning was introduced during the 1920s and continued to operate until the breakup of the Soviet Union in 1991.

Soviet planners were most concerned with building national power and prestige in the international community. As a result, they allocated the best land, labor, and capital to the armed forces, space program, and production of capital goods such as farm equipment and factories. The committees that ran the system were responsible for deciding the quantity, production process, and distribution of 24 million different goods and services.

Soviet Agriculture

In the Soviet Union, the central government created large state-owned farms and collectives for most of the country's agricultural production. On state-run farms, the state provided farmers with all equipment, seed, and fertilizer. Farmers worked for daily wages set by economic planners.

Collectives were large farms leased from the state to groups of peasant farmers. Farmers managed operation of the collectives, though they still were required to produce what the government instructed them to. Farmers either received a share of what they produced or income from its sale.

Agricultural workers were guaranteed employment and income, and the govern-

► How would you describe the farming techniques shown in this photo of a Soviet collective?

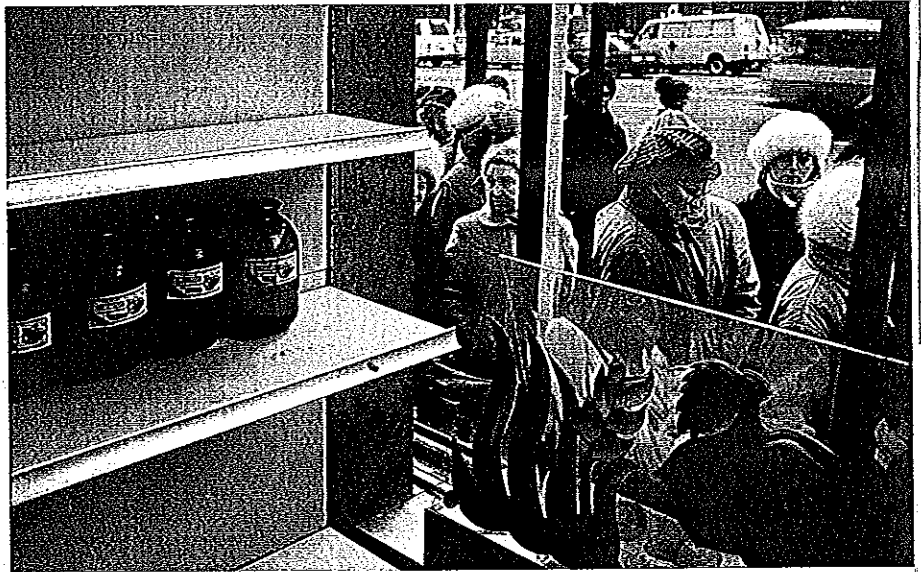


ment established quotas and distribution. Under such a system, individuals had few incentives to produce more or better crops. While Russia had been a major exporter of wheat until 1913, before long the Soviet Union could not keep its own people fed. Soviet agriculture bore much of the opportunity cost of Soviet central planning decisions.

Soviet Industry

Soviet factories also were state-owned. Planners favored the defense industry, the space program, and **heavy industry**. (Heavy industry requires a large capital investment to produce items used in other industries. Chemical, steel, and heavy machinery manufacturing are heavy industries.) The makers of consumer goods and services paid the opportunity cost of this concentration of resources. They were stuck with leftover, lower-quality resources with which to create their products.

Like agriculture, industry was characterized by a lack of incentives. Jobs were guaranteed, and wages were set by the government. Once a production quota was met, there was no reason to produce more goods. Workers had little incentive to work harder or to innovate. In fact, it was illegal for workers to exhibit entrepreneurial behavior.



▲ Shifting from communism to a free market economy has been a difficult transition. Consumers often waited hours in long lines only to discover nearly empty store shelves.

Soviet Consumers

Consumers, too, experienced the opportunity cost of central planners' decisions. Consumer goods were scarce and usually of poor quality. Manufacturers had the incentive to focus on quantity, not quality. For example, a manufacturer assigned to produce a certain number of suits could loosely stitch the buttons and forget the buttonholes and mismatch coats and trousers. Still, the state store had to accept delivery of the suits. Consumers would be left with no alternatives.

Consumers often had difficulty getting goods, too. They wasted countless hours waiting in line to purchase goods and services. Luxuries such as meat were made affordable by government price setting, but they were rarely available. Housing shortages forced people to live in crowded and poorly constructed apartments. Because of the long waiting list for apartments, it was not unusual to find a family living in just two rooms.

heavy industry industry that requires a large capital investment and that produces items used in other industries

THE WALL STREET JOURNAL. CLASSROOM EDITION

In the News When Alexander Lukashenko became president of Belarus in 1994, the former Soviet republic retreated to a centrally planned economy. As this excerpt from a Wall Street Journal Classroom Edition article shows, entrepreneurship was discouraged.

City authorities in Minsk "threw the book at Patio Pizza's pasta. Inspectors from the Public Nutrition Department, or Obshepit, decreed the restaurant's menu wasn't in keeping with the official Belarussian cookbook, a 200-page tome designed to guarantee that national dishes are prepared exactly the same way throughout Minsk. For this and [various] other violations, including unauthorized ice levels in [drinks], the city closed the restaurant."





▲ Statues of Lenin were toppled after the collapse of communism in the Soviet Union in 1991.

Problems of Centrally Planned Economies

Central planning can be used to jumpstart selected industries and guarantee jobs and income. The other side of the coin, however, is poor quality, serious shortages of non-priority goods and services, and diminishing production.

In theory, centrally planned economies can work effectively toward explicitly stated goals. For example, in 1928, Soviet leader Joseph Stalin instituted the first of

several five-year plans to boost production. While a disaster in terms of agriculture, Stalin had some success in increasing output in heavy industries.

Perhaps the greatest disadvantage of centrally planned economies is that their performance almost always falls far short of the ideals upon which the system is built. In addition, such systems generally cannot meet consumers' needs or wants. Since the government owns all production factors, workers lack any incentive to work hard. These systems also do not reward innovation, actively discouraging any kind of change. The large, expensive bureaucracy necessary to make the thousands of production and distribution decisions to run the economy lacks the flexibility to adjust to consumer demands. Decisions become overly complicated. Finally, command economies sacrifice individual freedoms in order to pursue societal goals.

Many areas of the world, especially less developed countries, have experimented with centrally planned economies, but most of these experiments have failed. Instead, most of these nations have moved toward mixed economies over the past twenty years. In the next section, you will read about today's mixed economies.

Section 3 Assessment

Key Terms and Main Ideas

1. How do socialism and communism differ?
2. What characterizes an authoritarian government?
3. Why did Soviet collectives offer little incentive to farmers?
4. In the Soviet Union, what was the opportunity cost of the emphasis on heavy industry?

Applying Economic Concepts

5. **Critical Thinking** Why do centrally planned economies have difficulty meeting consumer needs?
6. **Decision Making** Which of the following economic goals are difficult to achieve in a centrally planned economy? (a) economic efficiency (b) economic security and predictability (c) economic equity (d) economic growth and innovation



Take It to the NET

Russia, the dominant republic of the former Soviet Union, is now an example of a nation trying to make the transition from a centrally planned economy to a market economy. Identify and describe at least two actions taken to create a freer economy there. How well are these reforms working? Use the links provided in the Social Studies area at the following Web site for help in completing this activity. www.phschool.com

Real-life Case Study

Economic Systems

Russia in Crisis

In 1991, when the Communist system in Russia collapsed, many Russians rejoiced at the prospect of living under a freer political and economic system. Many specifically looked forward to living in a Western-style free market economy.

During the next decade, Russians experienced an economic crisis. Although economists had predicted that switching to a free enterprise system would be difficult, few predicted how traumatic it would be.

Corruption The confusion caused by the sudden upheaval of both the political and economic systems opened the door for crime and corruption on an enormous scale. Some businessmen and politicians took advantage of the nation's inexperience with a market economy and abused their power by robbing the nation's assets.

Financial Problems Russia's gross domestic product has shrunk nearly every year since the collapse of the Soviet Union. The nation has had to devalue its currency and postpone making payments on the loans it received from Western nations.

Hardest hit of all have been Russia's citizens. Some 40 million people live below the poverty line—defined as about \$30 a month. They have suffered through severe food shortages, and many workers have gone months without being paid.

Success Stories Although Russia's problems have been severe, it is possible for a nation to make the transition successfully. Poland, for example, has done so. In the years since the collapse of the Communist regime, Poland has become one of Europe's fastest-growing economies. Poland encourages small start-up companies and refuses to subsidize insolvent firms. Russia, on the other hand, actively discourages start-ups by requiring licensing and imposing other regulations. In Russia, insolvent businesses can still stay afloat because of the elaborate system of bartering among suppliers. This discourages Russian businesses from becoming more efficient.

It is now obvious that Russia's problems in making the transition were seriously underestimated. As this painful process continues, Russians continue to ask whether the nation will have the staying power to overcome these problems and make a free market economy a reality.

Applying Economic Ideas

1. What problems has Russia experienced in switching from a state-controlled to a free market economy?
2. Why might Western nations be willing to make loans to troubled Russia?



▲ Many Western businesses saw the collapse of Communism as a business opportunity.

Section 4

Modern Economies

Preview

Objectives

After studying this section you will be able to:

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. Understand the role of free enterprise in the economy of the United States.

Section Focus

It is doubtful that any nation can exist successfully under a pure centrally planned economy or a pure market economy. Most modern economies mix features of both systems. The economy of the United States is based on the principles of the free market.

Key Terms

laissez faire
private property
free enterprise
continuum
transition
privatize

You cannot find today any economic system that relies exclusively on central planning or the individual initiative of the free market. Instead, most economies are a mixture of economic systems. Most contemporary mixed economies blend the market with government intervention, or involvement, in the marketplace.

The Rise of Mixed Economies

No single economic system has all the answers. Centrally planned economies are

cumbersome, do not adequately meet consumer needs, and limit freedom. Traditional economies have little potential for growth or change. Even market economies, with all their advantages, have certain drawbacks.

The Limits of Laissez Faire

Adam Smith and other early free market philosophers believed that, left to its own devices, the free market system would provide the greatest benefit for consumers and raise the standard of living. They

► Most public parks rely on government dollars for support.



preached *laissez faire*, the doctrine that government generally should not intervene in the marketplace. (See the Profile of Adam Smith on page 33.) Even Smith acknowledged, however, the need for a certain limited degree of government intervention in the economy.

As market economies have evolved since Smith's time, government intervention has become greater because some needs and wants of modern society are difficult to answer in the marketplace. In addition, people's preferences for redistribution have changed.

Some needs that markets could meet fall to governments so that all members of society can participate. Education is one example. Other needs that could fall into this category are health care and mass transit.

Governments create laws protecting property rights and enforcing contracts. There would be little incentive to develop new products without property rights or patent laws (laws that give the inventor of a new product the exclusive right to sell it for a certain period of time). Without laws insisting on competition, many people fear that some firms would dominate others in their industry and be able to charge consumers any price.

You will recall from your study of American history that the 5th and 14th amendments to the Constitution declare that no person may be deprived of "Life, liberty, or property, without due process of law." The 5th Amendment also says that "just compensation" must be paid to owners when private property is taken for public use. **Private property** is property that is owned by individuals or companies, not by the government or the people as a whole. The Framers of the Constitution ensured that the United States government would protect this fundamental right.

Balancing Control and Freedom

A society must assess its values and prioritize its economic goals. Some goals are



◀ These kindergarten students in this school lunch program are enjoying a benefit of government intervention.

better met by the open market and others are better met by government action. In addition, societies must evaluate the opportunity cost of pursuing each goal.

Each nation decides what it is willing to give up to meet its goals. What are you willing to give up? Are you willing to pay taxes to fund the army? To give money to people without jobs? To give all people an education? To subsidize farms? Should the government establish job-safety guidelines or a minimum wage?

laissez faire the doctrine that states that government generally should not intervene in the marketplace

private property property owned by individuals or companies, not by the government or the people as a whole



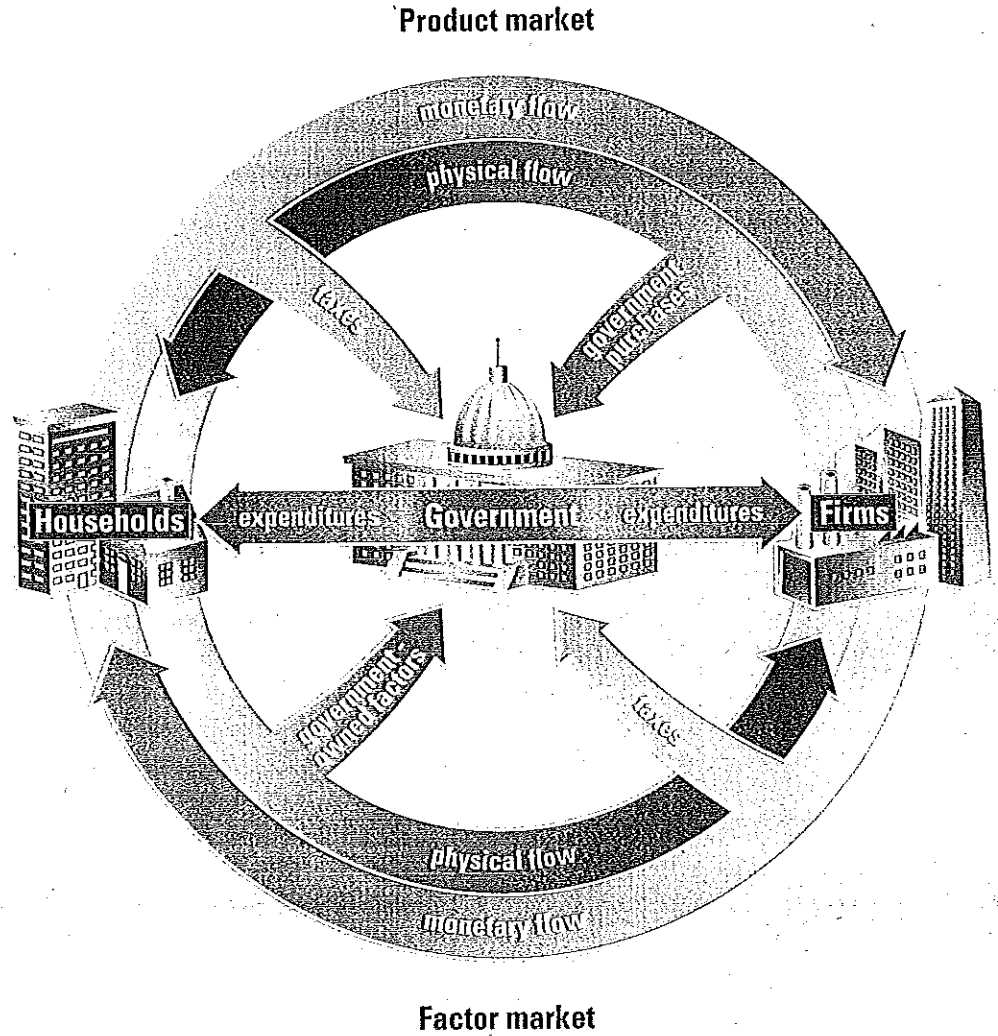
Global Connections

Sweden's Mixed Economy Sweden's mixed economy has mixed benefits for the Swedish people. The Swedish government redistributes more than half of Sweden's wealth through social benefit programs. When a child is born, his or her parents are entitled to a combined 450 days of parental leave, with three quarters of their base salary paid by the government. Swedish patients never pay more than 1,300 Swedish kronor (about \$170) per year for prescriptions. If you were a teen in Sweden, your new braces would be free. Employers are required to give employees a minimum of 30 days vacation. The trade-off for these benefits is the second-highest tax burden of any industrialized country. Swedes pay around 56 percent of their incomes in taxes, compared to only 32 percent in the United States. **How would you describe the level of government involvement in Sweden's economy?**



This circular flow model shows how government typically interacts with households and businesses in the marketplace. **Economic Systems Explain how government actions affect the circular flow model in a mixed economy.**

Figure 2.4 Circular Flow Model of a Mixed Economy



A Circular Flow Model of a Mixed Economy

To illustrate the structure of most modern economies accurately, we need to add government to our picture of the circular flow of economic activity. Figure 2.4 illustrates the government's role in the marketplace in a mixed economy. The government can enter the circular flow of economic activity in many ways.

Government in the Factor Market

Just like businesses, the government purchases land, labor, and capital from

households in the factor market. For example, the United States government pays 2.8 million employees \$9.7 billion a year for their labor.

Government in the Product Market

Governments purchase goods and services in the product market. They need buildings and office supplies, telephones, computers, and fax machines, for example.

Governments also provide certain goods and services through the factor resources that they combine. The federal, state, and local governments in the United States, for example, provide 4 million miles of roads.

Transferring Money

As you can see from the outer ring of Figure 2.4, governments collect taxes from both households and businesses. Governments then transfer the money they collect to businesses and individuals for a variety of reasons ranging from worker disability to the survival of an industry. The greatest expenditure of the United States government is Social Security.

Comparing Mixed Economies

The foundation of the United States economy is the free market. An economic system characterized by private or corporate ownership of capital goods is called **free enterprise**. In a free enterprise system investments are determined in a free market by private decision rather than by state control. Figure 2.5 below shows a continuum of mixed economies. A **continuum** is a range with no clear divisions. On one end of the scale is the centrally planned economy. On the opposite end is the free market economy.

Mixed Economies Where Government Intervention Dominates

Reflecting an economy almost totally dominated by the government, North Korea occupies one end of the scale.

Government owns all the property and all economic output. State-owned industries produce 95 percent of North Korea's goods. Almost all imports are banned, and production of goods and services by foreign companies is forbidden.

In China, where the economy is dominated by government, one quarter of all enterprises are at least partly owned by individuals. China, like many nations that have relied heavily on central planning in the past, is in **transition**, a period of change in which an economy moves away from central planning toward a market-based system. To make the transition, state firms must be **privatized**, or sold to individuals, and then allowed to compete with one another in the marketplace. As you will read in Chapter 18, economic transition is a difficult, and often painful, process.

Mixed Economies Where the Market System Dominates

At the other end of the scale, with one of the world's freest markets, is Hong Kong. Hong Kong, once administered by Great Britain, is now a special administrative region of China. It continues, at the beginning of the twenty-

FAST FACT

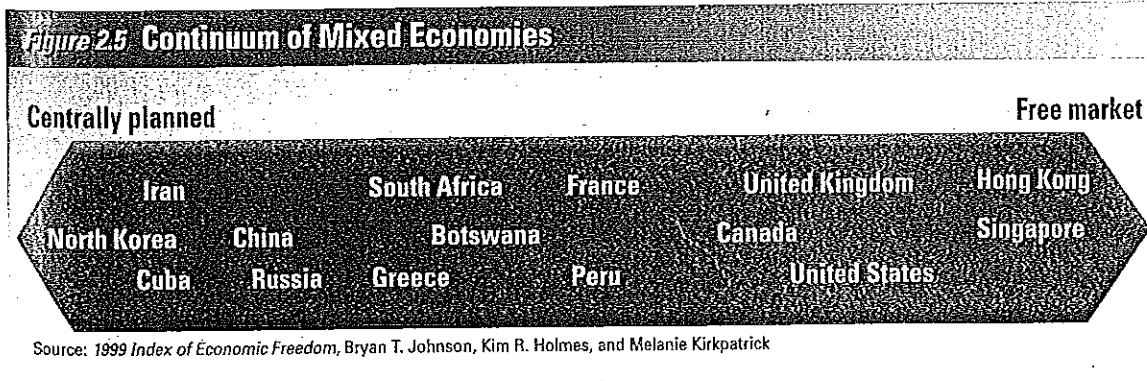
In competition with foreign fast-food restaurant chains, Chinese entrepreneur Shen Qing started his own restaurant chain—the Baked Pig Face restaurants. The seasoned pigs' heads, served in a modern setting, are wildly popular. Mr. Shen benefits by receiving profits, and consumers benefit by being able to choose a traditional Chinese dish over Western-style fast food.

free enterprise an economic system characterized by private or corporate ownership of capital goods; investments that are determined by private decision rather than by state control; and determined in a free market

continuum a range with no clear divisions

transition period of change in which an economy moves away from a centrally planned economy toward a market-based system

privatize to sell state-run firms to individuals



The degree of government intervention in the marketplace varies among nations. Economic Systems How would you explain China's position on this continuum? Why is Hong Kong, technically part of China, so far to the right on this diagram?

► What type of economic system do you see reflected in this busy mall?



first century, largely under the free economic system it enjoyed under British rule.

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. It is highly receptive to foreign investment and imposes virtually no barriers on

foreign trade. Banks in Hong Kong operate independently of the government, and foreign-owned banks have nearly all the same rights as domestic ones.

The United States Economy

The United States has a free enterprise economy. Still, the government intervenes to keep order, provide vital services, and to promote the general welfare. Some people argue for more government services, while others say that the government already intervenes too much in the economy. Nevertheless, the United States enjoys a high level of economic freedom.

United States law protects private property. The marketplace operates with a low level of government regulation. Foreign investment is encouraged. So, too, is free trade, although the United States does protect some domestic industries and does retaliate against trade restrictions imposed by other nations. The banking industry operates under relatively few restrictions, and foreign-owned banks have few additional restrictions. In the next chapter, you will read in detail about the government and the free enterprise economy of the United States.

Section 4 Assessment

Key Terms and Main Ideas

1. What is *laissez faire*?
2. Why have some nations begun a **transition to free enterprise**?
3. Why are nations with centrally planned economies sometimes slow to succeed when they **privatize industry**?
4. Compare the U.S. free enterprise system with other economic systems you have read about in this chapter.

Applying Economic Concepts

5. **Critical Thinking** What benefits might citizens of a centrally planned economy derive from a move toward a market-based system?
6. **Try This** Survey newspapers and magazines to find articles describing life in different economic systems. Construct a bulletin board of the continuum of economies in Fig. 2.5. Place each article on the appropriate location on the continuum.



Take It to the NET

Identify four agencies or organizations in the United States government that play a direct role in the nation's economy. Write down each agency's name and purpose. What are the advantages and disadvantages of this government intervention in the marketplace? Use the links provided in the Social Studies area at the following Web site for help in completing this activity. www.phschool.com

Skills for LIFE

Critical Thinking

Graphs and Charts

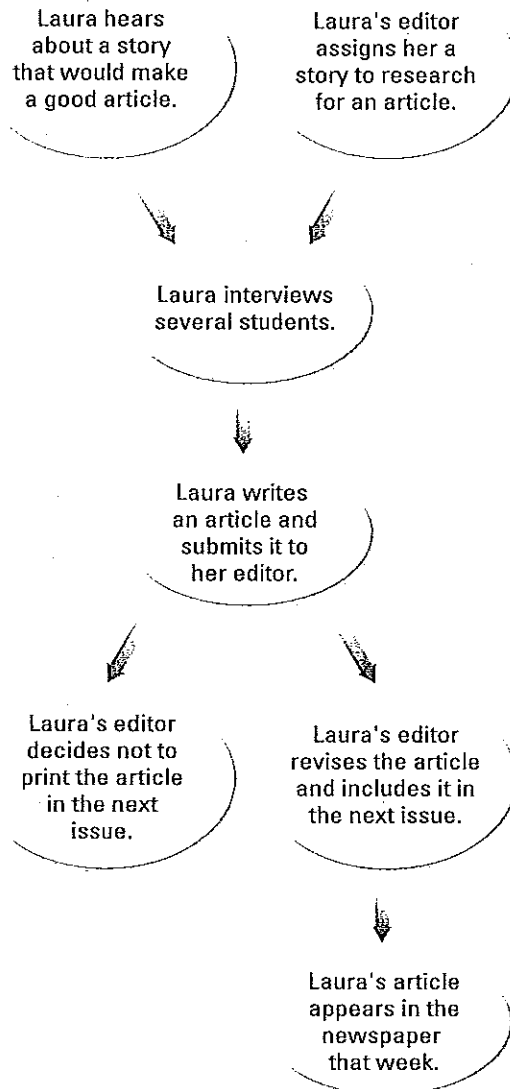
Social Studies

Technology

Building Flowcharts

A flowchart is a visual guide to a process that breaks the process down into individual steps. Arrows often indicate the order and relationships among the steps. In economics, flowcharts help people visualize the ways goods are produced, how money flows through the economy, and how decisions can affect many people. Use the following steps to analyze the flowchart below.

1. **Identify the steps of the process.** Read the labels in the boxes to familiarize yourself with the process of writing an article. (a) What does Laura do



after she interviews people for the article? (b) What are the two choices for step one of the process?

2. **Analyze the relationships among steps.** A flowchart shows a series of actions and decisions. (a) According to this particular chart, who can make a decision that directly affects the flow? (b) Why does the path split into two new paths after Laura submits the article to her editor?

3. **Predict possible future developments.** New arrows and steps can be added anywhere along the flowchart, not just at the ends. Picture how different decisions and actions might change the look of Laura's flowchart. (a) Where else might the flowchart split into two new paths? (b) Give an example of a new step that could be added to start a new path.

Additional Practice

Construct a flowchart to show the steps that you could take to offer a new product for sale in your small food store.

Chapter 2 Assessment

Chapter Summary

A summary of the major ideas in Chapter 2 appears below. See also the *Guide to the Essentials of Economics*, which provides additional review and test practice of key concepts in Chapter 2.

Section 1 Answering the Three Economic Questions (pp. 23–27)

The three basic economic questions societies ask are (1) What goods and services should be produced? (2) How should these goods and services be produced? and (3) Who consumes these goods and services? An **economic system** is the way a society decides to answer these three economic questions. There are four general types of economic systems: **traditional economies**, **market economies**, **centrally planned (or command) economies**, and **mixed economies**.

Section 2 The Free Market (pp. 28–32)

A free market is a self-regulating economic system powered by individuals acting in their own **self-interest**. In a free market economy, the factors of production are privately owned, and individuals decide how to answer the three economic questions.

Section 3 Centrally Planned Economies (pp. 34–38)

In a **centrally planned economy** the central government controls the factors of production and answers the three basic economic questions for all of society. Two systems often mentioned when centrally planned economies are discussed are **socialism** and **communism**.

Section 4 Modern Economies (pp. 40–44)

Most of the economic systems in the world today are mixed economies. These systems use a combination of government involvement and free markets. Throughout the world there are different levels of government intervention in mixed economies.

Key Terms

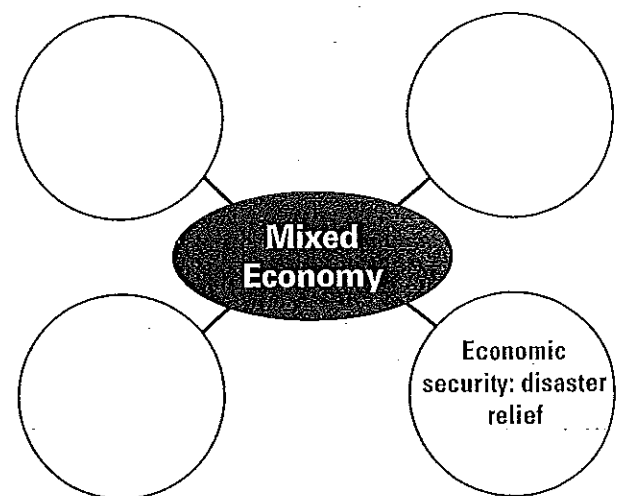
Match the following terms with the definitions listed below. You will not use all of the terms.

competition	laissez faire
socialism	privatize
mixed economy	consumer
self-interest	sovereignty
command economy	market economy

1. System that combines the free market with some government intervention
2. One's own personal gain
3. The doctrine that states that government generally should not intervene in the marketplace
4. System in which the central government makes all decisions on the production and consumption of goods and services
5. The struggle among producers for the dollars of consumers
6. System in which decisions on production and consumption of goods and services are based entirely on exchange, or trade

Using Graphic Organizers

7. On a separate sheet of paper, copy the web map below showing the advantages and values of a mixed economy. Complete the web map with examples from your knowledge or experience.



Reviewing Main Ideas

8. Think of a business in your local area. Describe its operation in terms of factor markets and product markets.
9. Explain how a factory assembly line is an example of specialization.
10. Why are there no pure free market economies in the world?
11. Compare the circular flow diagrams of a free market and a mixed economy. Describe how they differ, and why.

Critical Thinking

12. **Synthesizing Information** Suppose that your household is its own society. How are the three key economic questions answered?
13. **Predicting Consequences** Think of three ways your life would change if the United States began using a pure free market system or a pure centrally planned system instead of the free enterprise system.
14. **Analyzing Information** Review the advantages and disadvantages of both free market economies and centrally planned economies. Assess the way each system values economic freedom and economic equity.

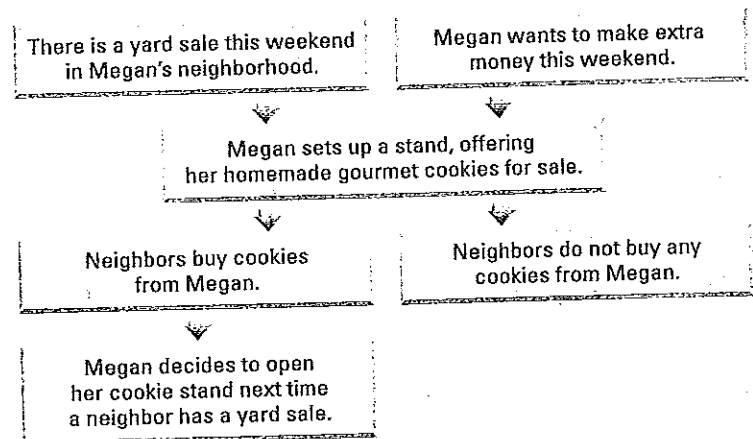
Problem-Solving Activity

15. Suppose that you are opening a new music store in your town. What resources would you need from the factor market? What would you offer in the product market? How would the government affect your business?

Skills for Life

Building Flowcharts Review the steps on page 45; then answer the following questions using the flowchart below.

16. What does Megan do to try to make extra money this weekend?
17. Why does the flowchart split into two paths after Megan sets up her stand?
18. What step does Megan take if the neighbors like her cookies?
19. If the neighbors do not like cookies, where could a step or steps be added so Megan could succeed next time?
20. Organize a flowchart for yourself depicting a goal that you did not achieve. (a) Take a close look at the steps you took. (b) What errors did you make? (c) Decide which steps you can change so you can succeed in the future.



Economics Journal

Organizing Ideas Review your personal list of systems. Rewrite your list in two columns. In one column, list the systems that are more influenced by central planning. In the other column, list the ones that are more influenced by the free market. Add to each list other systems you use on a regular basis.



Take It to the NET

Chapter 2 Self-Test As a final review activity, take the Economics Chapter 2 Self-Test in the Social Studies area at the Web site listed below, and receive immediate feedback on your answers. The test consists of 20 multiple-choice questions designed to test your understanding of the chapter content.
www.phschool.com