

# Answering the Three Economic Questions

- **What key economic questions must every society answer?**
- **What basic economic goals do societies have?**
- **What types of economic systems exist today?**



# The Three Economic Questions

- **Every society must answer three questions:**
  - **What goods and services should be produced?**
  - **How should these goods and services be produced?**
  - **Who consumes these goods and services?**



# Economic Goals

- **Societies answer the three economic questions based on their values.**

Economic Goals	
<b>Economic efficiency</b>	Making the most of resources
<b>Economic freedom</b>	Freedom from government intervention in the production and distribution of goods and services
<b>Economic security and predictability</b>	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
<b>Economic equity</b>	Fair distribution of wealth
<b>Economic growth and innovation</b>	Innovation leads to economic growth, and economic growth leads to a higher standard of living.
<b>Other goals</b>	Societies pursue additional goals, such as environmental protection.



# Four Economic Systems

**An economic system is the method used by a society to produce and distribute goods and services.**

**Traditional economies** rely on habit, custom, or ritual to decide what to produce, how to produce it, and to whom to distribute it.

In a **centrally planned economy** the central government makes all decisions about the production and consumption of goods and services.

In a **market economy** economic decisions are made by individuals and are based on exchange, or trade.

**Mixed economies** are systems that combine tradition and the free market with limited government intervention.



# Combining Factor Resources



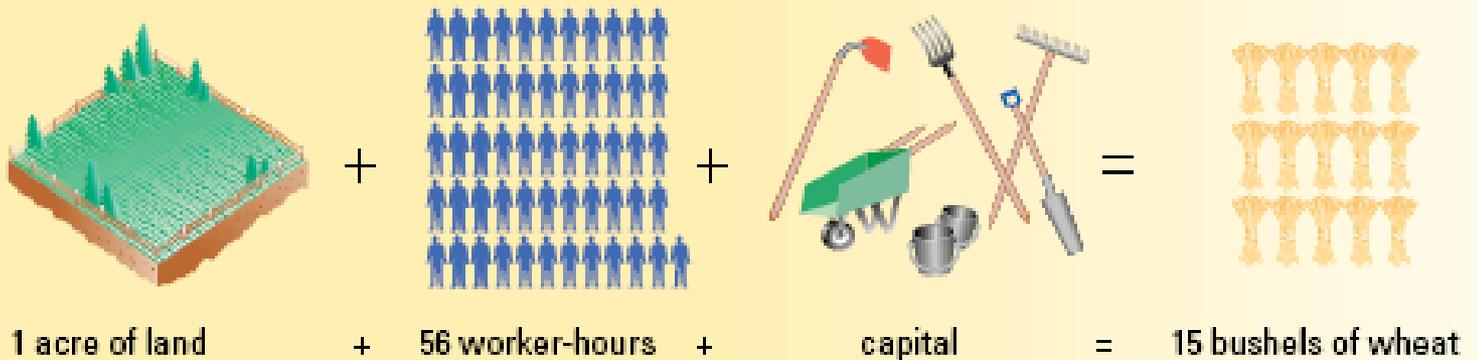
Today, capital—not labor—dominates the answer to how wheat is produced.

**Opportunity Cost**  
Identify the opportunity costs of each method of farming.

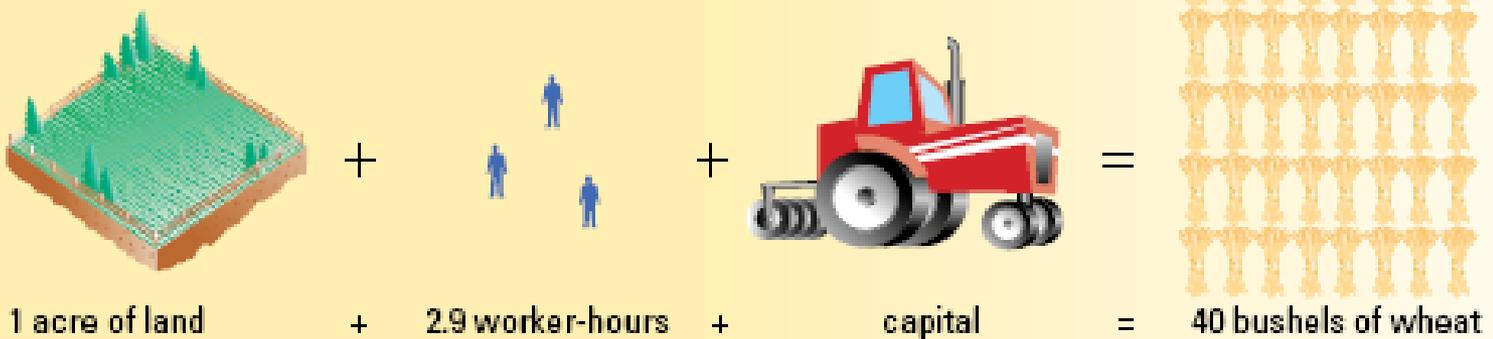
**OPPORTUNITY COST**  
most desirable alternative given up as the result of a decision

Figure 2.1 Combining Factor Resources

## Hand tools



## Modern mechanical equipment



# Section 1 Assessment

1. Each society determines who will consume what is produced based on
  - (a) its unique combination of social values and goals.
  - (b) the amount of factor payments.
  - (c) its needs and wants.
  - (d) economic equity.
2. To improve its standard of living, a nation's economy must
  - (a) remain stable.
  - (b) grow through innovation.
  - (c) reach economic equity.
  - (d) allow the central government to make economic decisions.

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# The Free Market

- How do free markets operate?
- How can markets regulate themselves?
- What are the advantages of a free market economy?

# Why Do Markets Exist?

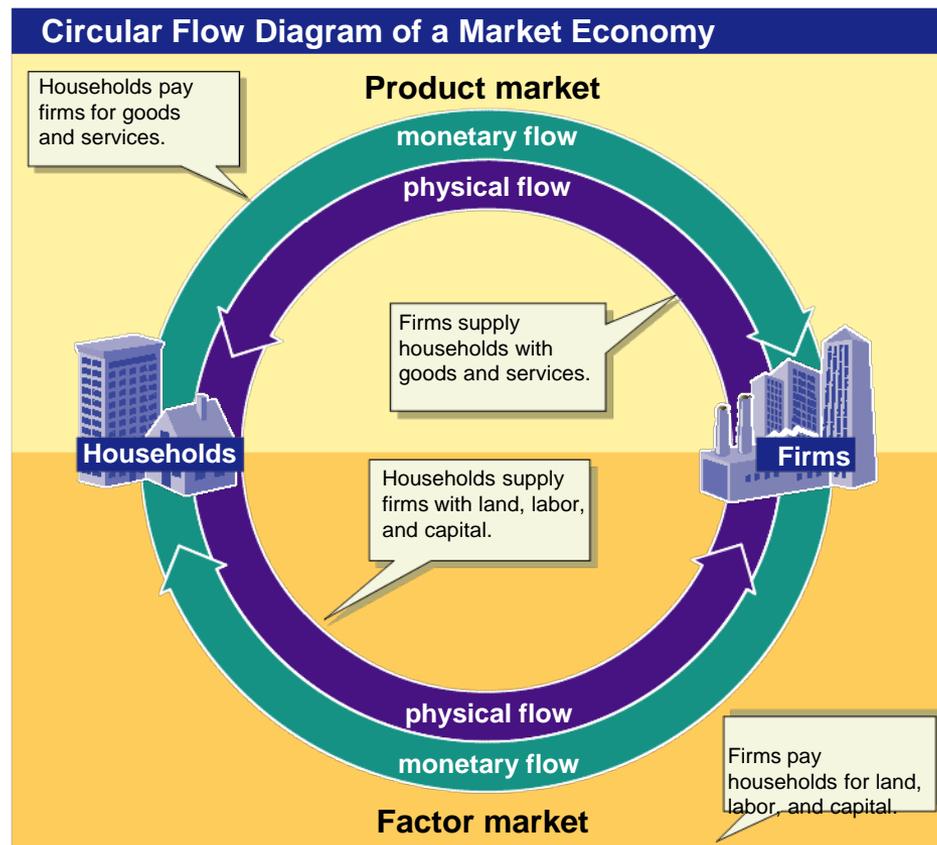
**Markets exist because none of us produces all the goods and services we require to satisfy our needs and wants.**

A **market** is an arrangement that allows buyers and sellers to exchange goods and services.

**Specialization** is the concentration of the productive efforts of individuals and firms on a limited number of activities.

# The Free Market Economy

- 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.



# The Market's Self-Regulating Nature

- In every transaction, the buyer and seller consider only their **self-interest**, or their own personal gain. Self-interest is the motivating force in the free market.
- Producers in a free market struggle for the dollars of consumers. This is known as **competition**, and is the regulating force of the free market.
- The interaction of buyers and sellers, motivated by self-interest and regulated by competition, all happens without a central plan. This phenomenon is called “the **invisible hand** of the marketplace.”

# Advantages of the Free Market

## Economic Efficiency

- As a self-regulating system, a free market economy is efficient.

## Economic Growth

- Because competition encourages innovation, free markets encourage growth.

## Economic Freedom

- Free market economies have the highest degree of economic freedom of any economic system.

## Additional Goals

- Free markets offer a wider variety of goods and services than any other economic system.



## 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.



# Section 2 Assessment

1. Why do people need to buy and sell goods or services?
  - (a) People need to buy and sell goods to make a profit.
  - (b) People buy and sell to maintain a competitive society.
  - (c) No one is self-sufficient.
  - (d) People need to provide the market with goods and services.
2. What factors create the phenomenon of the “invisible hand”?
  - (a) incentives and efficiency
  - (b) specialization and efficiency
  - (c) competition between firms
  - (d) competition and self-interest

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# Centrally Planned Economies

- **How are centrally planned economies organized?**
- **How did the centrally planned economy of the former Soviet Union function?**
- **What problems exist within centrally planned economies?**

# Organization of Centrally Planned Economies

In a **centrally planned economy**, the government owns both land and capital. The government decides what to produce, how much to produce, and how much to charge.

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

**Communism** is a political system characterized by a centrally planned economy with all economic and political power resting in the hands of the government.

# The Former Soviet Union

- **Soviet Agriculture**
  - In the Soviet Union, the government created large state-owned farms and collectives for most of the country's agricultural production.
- **Soviet Industry**
  - Soviet planners favored heavy-industry production (such as steel and machinery), over the production of consumer goods.
- **Soviet Consumers**
  - Consumer goods in the Soviet Union were scarce and usually of poor quality.

# Problems of a Centrally Planned Economy



**Centrally planned economies face problems of poor-quality goods, shortages, and diminishing production.**

# Section 3 Assessment

1. In a socialist country,
  - (a) central planning is unnecessary.
  - (b) the government often owns major industries, such as utilities.
  - (c) an authoritarian government controls the economy.
  - (d) economic equality is not important.
2. Which of the following is an advantage of a centrally planned economy?
  - (a) the system's bureaucracies are small and flexible
  - (b) the system can work quickly to accomplish specific goals
  - (c) innovation is well rewarded
  - (d) consumers' needs are well met

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# Modern Economies

- **Why are many modern economies mixed economies?**
- **What role does the government play in a mixed economy?**
- **How do mixed economies in different countries compare?**
- **What role does free enterprise play in the United States economy?**

# The Rise of Mixed Economies

Market economies, with all their advantages, have certain drawbacks.

## Limits of Laissez Faire

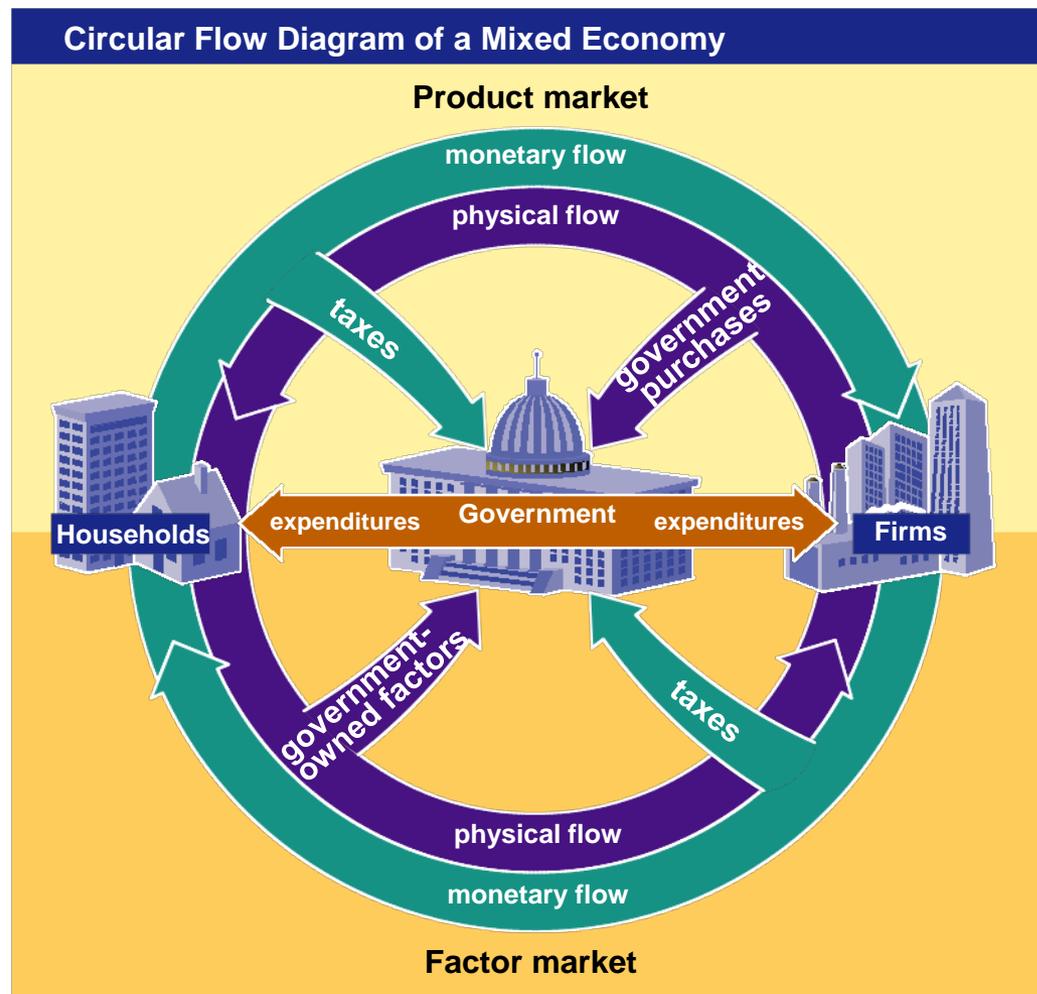
**Laissez faire** is the doctrine that government generally should not interfere in the marketplace.

Governments create laws protecting property rights and enforcing contracts. They also encourage innovation through patent laws.

# Government's Role in a Mixed Economy

In a mixed economy,

- The government purchases land, labor, and capital from households in the factor market, and
- Purchases goods and services in the product market.



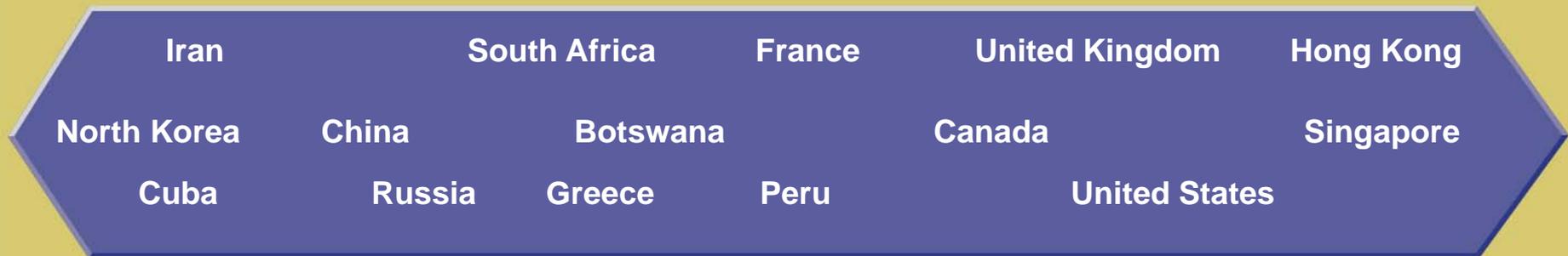
# Comparing Mixed Economies

- 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.

## Continuum of Mixed Economies

Centrally planned

Free market



Source: 1999 *Index of Economic Freedom*, Bryan T. Johnson, Kim R. Holmes, and Melanie Kirkpatrick

# Section 4 Assessment

1. **The United States economy is a mixed economy**
  - (a) based on the principle of a traditional economy, but allows some government intervention.
  - (b) based on the principles of a centrally planned economy, with limited government intervention.
  - (c) based on the principles of the free market, and allows no government intervention.
  - (d) based on the principles of the free market, but allows some government intervention.
  
2. **Government intervention in a modern economy is useful because**
  - (a) the needs and wants of modern society are always met by the marketplace.
  - (b) the marketplace has many incentives to create public goods such as parks and libraries.
  - (c) governments are able to provide some goods and services that the marketplace has no incentive to produce.
  - (d) the marketplace provides all of its own laws.

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