

CHAPTER
2

Economic Systems

SECTION 1

ANSWERING THE THREE ECONOMIC QUESTIONS

TEXT SUMMARY

Because economic resources are limited, a country must answer three key economic questions. These are: 1) What goods and services should be produced? 2) How should these goods and services be produced? 3) Who consumes these goods and services?

Four types of **economic systems** have developed as societies attempt to answer the three economic questions according to their goals. An economic system is the method a society uses to produce and distribute goods and services. A **traditional economy** relies on custom to make most economic decisions. People grow up doing what their parents did, and there is little innovation or change. In a **market economy**, economic decisions are made by individuals and are based on exchange, or trade. Market economies are also known as the free market. In a **centrally planned economy**, the government makes most economic decisions. Most economies today are **mixed economies**, a combination of the three other economic systems.

THE BIG IDEA

All countries must answer three key economic questions in deciding how to use their scarce economic resources.

In answering these questions, societies must consider their economic goals. Some goals, such as economic freedom or economic equity, are considered more important in some countries than in others. Other goals, like economic efficiency, are shared

by most countries. Another important goal is growth and innovation. A nation's economy must grow in order to improve its **standard of living**, or level of prosperity.

GRAPHIC SUMMARY: Economic Goals

| ECONOMIC EFFICIENCY | ECONOMIC FREEDOM | ECONOMIC SECURITY AND PREDICTABILITY | ECONOMIC EQUITY | ECONOMIC GROWTH AND INNOVATION |
|--|--|--|---|---|
| Maximizing output of goods and services from the resources available | Allowing individuals to make economic choices about earning income, owning property, and purchasing goods and services | Assuring people that goods and services will be available; providing aid for retirement and in difficult times | Dividing resources in a way that is considered fair | Encouraging the development of new ideas and skills; helping the economy grow |

While most societies pursue all of these goals, a society may value some goals more than others.

REVIEW QUESTIONS

1. How are decisions made in a market economy?
2. **Chart Skills** What is economic efficiency?

TEXT SUMMARY

None of us can produce everything we need and want. **Markets** exist so that people can exchange the things they have for the things they want. A market is an arrangement that allows buyers and sellers to exchange goods and services.

Markets function because of self-interest and competition. **Self-interest** means buyers and sellers are focused on personal gain. It motivates consumers to buy the goods and services they want at the lowest prices possible. **Competition** is the struggle among producers for the dollars of consumers. It keeps prices low as firms attempt to make their prices attractive to consumers. Together, self-interest and competition work to regulate the marketplace.

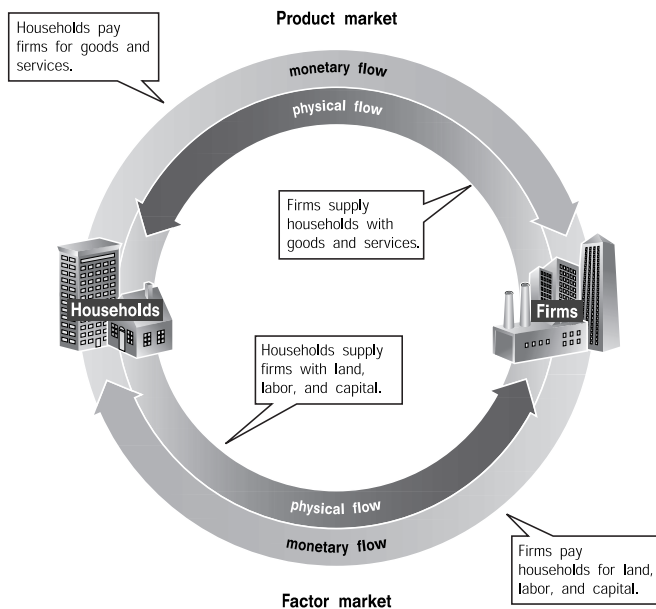
The factor market and the product market are the two main parts of the free market. In the **factor market**, firms purchase land, labor, and capital—the factors of production—from households. Firms rent land, hire workers, and borrow money from investors. In the **product market**, households purchase goods and services produced by firms.

The free market helps an economy meet many economic goals. It encourages efficiency, economic freedom, and innovation and growth. However, two other economic goals—security and equity—are difficult to achieve in a pure market system. Many societies have modified the free market to better meet their goals.

THE BIG IDEA

The free market system, based on self-interest and competition, has many advantages for societies that are attempting to meet their economic goals.

GRAPHIC SUMMARY: Factor Market and Product Market



This circular flow diagram shows interactions between businesses and households in the free market. In the top half, households purchase products made by businesses. In the bottom half, businesses purchase land, labor, and capital from households.

REVIEW QUESTIONS

1. What is competition, and what function does it serve in the free market?

2. **Diagram Skills** With what do firms supply households?

CENTRALLY PLANNED ECONOMIES

TEXT SUMMARY

In a centrally planned economy, the central government, rather than individual producers and consumers in markets, answers the key economic questions about production and consumption. The government owns the land and the capital. It controls where people will work and how much they will be paid. It decides what is produced and at what price things will be sold.

The terms **socialism** and **communism** are associated with centrally controlled economies. Socialists attach great value to the goal of economic equity. They believe that economic equality is possible only if the public controls the economy. Socialist countries may be democracies. Communists share many of the goals of socialists, but believe that these goals can only be achieved through violent revolution.

In a communist society, individuals lack personal freedom.

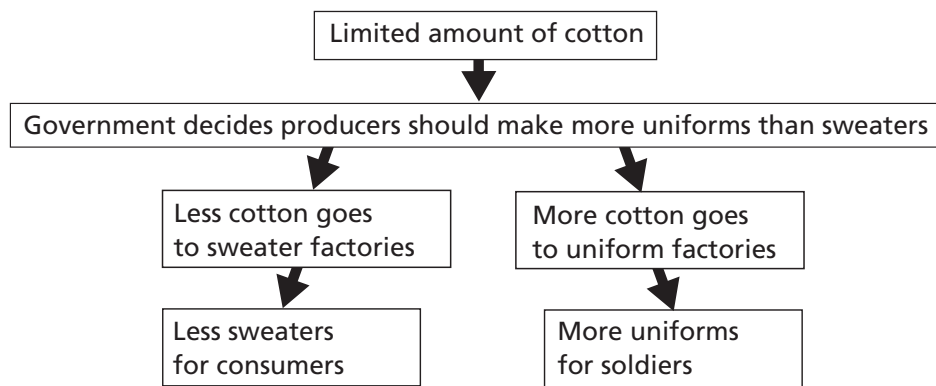
The former Soviet Union was an example of a communist nation where most economic and political power was controlled by the central government. Under the Soviet system all workers were guaranteed employment and income. Factories and farms had to meet production goals set by the government.

Centrally planned economies try to promote faster economic growth and more equal distribution of goods and services. However, these systems almost always fall short of their goals. Without the incentive of self-interest, producers have no reason to produce more or better products. Consumers find it difficult to meet their needs or wants, having to accept poorly-made merchandise. In addition, individual freedoms are limited.

THE BIG IDEA

Centrally planned economies have disadvantages not found in market economies.

GRAPHIC SUMMARY: Decision Making in a Centrally Planned Economy



In centrally planned economies the government makes all important economic decisions.

REVIEW QUESTIONS

1. In a centrally planned economy who decides how much goods will cost?

2. **Diagram Skills** How does the government's decision affect consumers and soldiers?

TEXT SUMMARY

No economic system has all the answers. The traditional economy offers little hope for growth or change. The centrally planned economy is slow-moving and offers consumers few choices or freedom. Market economies have many advantages but also have their limitations. For example, markets do not provide answers for some of society's needs, such as the need for defense, education, and fast transportation routes. Governments provide answers to these needs by maintaining armed forces, schools, and roads and bridges. Governments also enforce property rights and rules against unfair competition.

No country has an economy that is purely free market or purely controlled by the government. All are mixed economies, combining free markets with

government intervention, or involvement. There is a **continuum**—a range with no clear divisions—of economic systems. At one extreme, the North Korean economy is almost completely controlled by the government. China has a centrally planned economy but is in **transition**, a period of change, moving toward a market system. Hong Kong is governed by China, but has a separate economic system based on its years as a colony of Great Britain. This system is dominated by free markets.

Compared to most other nations, the United States has an economy with little government involvement and a great deal of economic freedom. Such a system is called **free enterprise**.

THE BIG IDEA

Most nations have mixed economies, which combine features of both centrally planned and free market economies.

GRAPHIC SUMMARY: A Continuum of Economic Systems



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

The world's nations vary greatly in economic systems. The left side of the diagram shows economies dominated by government. The right side shows economies dominated by the free market.

REVIEW QUESTIONS

1. What are examples of needs that are not easily met by free markets?

2. **Diagram Skills:** Which economies are at opposite ends of the range of economic systems?

CHAPTER 2**Test****IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. Which of these is a key economic question faced by countries?
- A. How big should the army be?
 - B. How much money should be raised in taxes?
 - C. How many schools should be built?
 - D. What goods and services should be produced?
- _____ 2. In a traditional economy, economic decisions are based largely on
- A. custom.
 - B. science.
 - C. socialism.
 - D. technology.
- _____ 3. Markets allow us to
- A. get the highest prices for what we sell.
 - B. get the lowest prices for what we buy.
 - C. sell the most goods we possibly can.
 - D. exchange the things we have for the things we need.
- _____ 4. Competition and self interest are two important forces in
- A. free market economies.
 - B. traditional economies.
 - C. centrally planned economies.
 - D. communist economies.
- _____ 5. Which economic goals are best promoted by the free market?
- A. efficiency and freedom
 - B. efficiency and equity
 - C. innovation and security
 - D. Freedom and security
- _____ 6. Which is true of the government in a centrally planned economy?
- A. It builds every house in every village.
 - B. It encourages workers to innovate.
 - C. It makes all important economic decisions.
 - D. It places much emphasis on the production of consumer goods.
- _____ 7. Socialists believe that economic equality is only possible if
- A. everyone makes the same amount of money.
 - B. the public controls the economy.
 - C. medical care is free.
 - D. no one has to pay taxes.
- _____ 8. The former Soviet Union was an example of a communist country where
- A. individual freedom was allowed.
 - B. free enterprise was encouraged.
 - C. consumers had many choices.
 - D. most economic and political power was controlled by the government.
- _____ 9. Which of the following countries has the most extreme example of a centrally planned economy?
- A. North Korea
 - B. Hong Kong
 - C. China
 - D. Great Britain
- _____ 10. The free enterprise system of the United States is best described as a
- A. free market economy.
 - B. traditional economy.
 - C. mixed economy with limited government intervention and a great deal of economic freedom.
 - D. mixed economy with equal amounts of economic freedom and government intervention.