

## **Economic Systems**

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.

1. What is an economic system?
2. What three economic questions must every society answer?
3. What is a factor payment?
4. How do a traditional economy, a market economy, a command economy, and a mixed economy differ?
5. Why aren't all people paid the same amount in factor payments for the resource they provide? Provide your own example of two unequal factor payments.
6. What is a safety net?
7. Why do governments provide safety nets for their citizens?
8. What is a standard of living?

9. Describe and give at least one example of each

Traditional	Command	Market

10. What is a mixed economy?

11. You decide to earn money by washing cars. How are the three economic questions answered in this market.



## The Free Market

Use pages 28-33 to complete the following

Define each

Market	
Factor Market	
Profit	
Product Market	
Incentive	
Competition	
Invisible Hand	
Consumer Sovereignty	

1. How does specialization make us more efficient?
2. What are the roles of households and firms in a market economy?
3. How does competition among firms benefit consumers?
4. What is the connections between incentives and consumer sovereignty in a free market economy?
5. Why is economic equity difficult to achieve in a free market economy?
6. Who was Adam Smith? Why is he important?

7. What is laissez faire?
  
8. Describe the invisible hand and self-interest.

## **Centrally Planned Economies**

**Pages 34-38**

### **Terms to Know**

Socialism-

Communism-

Authoritarian-

Heavy Industry-



- 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?**

# Modern Economies

Use pages 40-44

## Define the terms

Laissez faire-

Private Property-

Free Enterprise-

Continuum-

Transition-

Privatize-

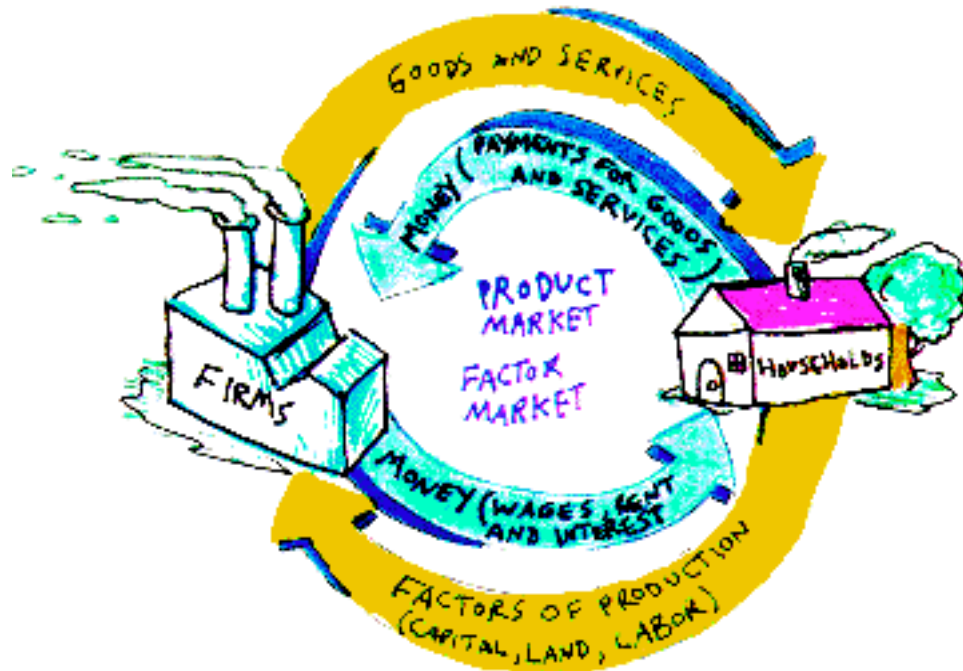


## Answer the following

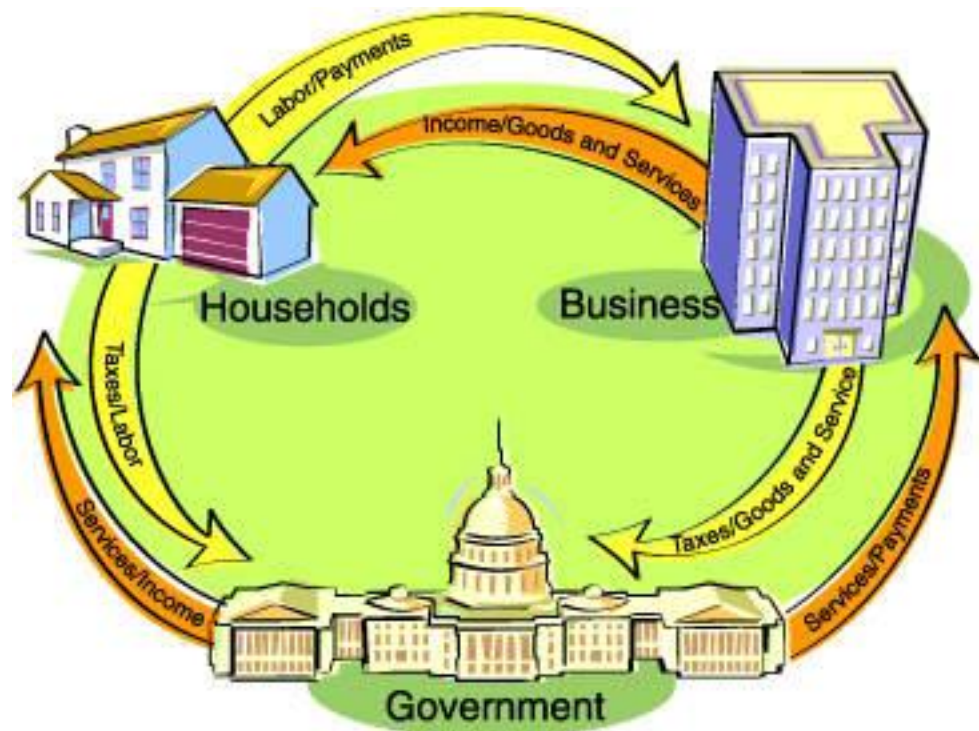
1. Why have some nations begun a transition to free enterprise?
2. Why are nations with centrally planned economies sometimes slow to succeed when they privatize industry?
3. When you look at figure 2.5 (Continuum of Mixed Economies on page 43), how would you explain China's position on the continuum? Why is Hong Kong, technically part of China, so far to the right on the diagram?

# Circular Flow

## Circular Flow Model of a Market Economy



## Circular Flow Model of a Mixed Economy



## John Maynard Keynes

So influential was John Maynard Keynes in the middle third of the twentieth century that an entire school of modern thought bears his name. Many of his ideas were revolutionary; almost all were controversial. **KEYNESIAN ECONOMICS** serves as a sort of yardstick that can define virtually all economists who came after him.

Keynes became a celebrity before becoming one of the most respected economists of the century when his eloquent book *The Economic Consequences of the Peace* was published in 1919. Keynes wrote it to object to the punitive reparations payments imposed on Germany by the Allied countries after World War I. The amounts demanded by the Allies were so large, he wrote, that a Germany that tried to pay them would stay perpetually poor and, therefore, politically unstable. We now know that Keynes was right. Keynes's developed new ideas about economic policy in the 1930s as **UNEMPLOYMENT** in Britain dragged on during the interwar period, reaching levels as high as 20 percent. Keynes investigated other causes of Britain's economic woes, and *The General Theory of Employment, Interest and Money* was the result.

Keynes's *General Theory* revolutionized the way economists think about economics. It was pathbreaking in several ways, in particular because it introduced the notion of aggregate demand as the sum of consumption, **INVESTMENT**, and government spending; and because it showed (or purported to show) that full employment could be maintained only with the help of government spending. Economists still argue about what Keynes thought caused high unemployment. Some think he attributed it to wages that take a long time to fall. But Keynes actually wanted wages not to fall, and in fact advocated in the *General Theory* that wages be kept stable. A general cut in wages, he argued, would decrease income, consumption, and aggregate demand. This would offset any benefits to output that the lower price of labor might have contributed.

Why shouldn't government, thought Keynes, fill the shoes of business by investing in public works and hiring the unemployed? *The General Theory* advocated deficit spending during economic downturns to maintain full employment. Keynes's conclusion initially met with opposition. At the time, balanced budgets were standard practice with the government. But the idea soon took hold and the U.S. government put people back to work on public works projects. Of course, once policymakers had taken deficit spending to heart, they did not let it go.

Contrary to some of his critics' assertions, Keynes was a relatively strong advocate of free markets. . . . Keynes believed that once full employment had been achieved by **FISCAL POLICY** measures, the market mechanism could then operate freely. "Thus," continued Keynes, "apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialize economic life than there was before" (p. 379).

## Hayek

Hayek believed that individuals and businesses need as much freedom as possible in order to be successful.

Much of the knowledge necessary for running the economic system, Hayek contended, is often not consciously known even to those who possess it and can never be communicated to a central authority. The market tends to use this tacit knowledge through a type of "discovery procedure" (Hayek, 1968a), by which this information is unknowingly transmitted throughout the economy as an unintended consequence of individuals' pursuing their own ends.

For Hayek, market competition generates a particular kind of order--an order that is the product "of human action but not human design" (a phrase Hayek borrowed from Adam Smith's mentor Adam Ferguson). This "spontaneous order" is a system that comes about through the independent actions of many individuals, and produces overall benefits unintended and mostly unforeseen by those whose actions bring it about.

Most commentators view Hayek's work on knowledge, discovery, and competition as an outgrowth of his participation in the socialist calculation debate of the 1920s and 1930s. The socialists erred, in Hayek's view, in failing to see that the economy as a whole is necessarily a spontaneous order and can never be deliberately made over in the way that the operators of a planned order can exercise control over their organization. This is because planned orders can handle only problems of strictly limited complexity. Spontaneous orders, by contrast, tend to evolve through a process of natural selection, and therefore do not need to be designed or even understood by a single mind.<sup>(20)</sup>

Therefore, it is almost impossible for any government to create a successful economic policy. Governments should leave individuals to solve problems on their own.

