

CHAPTER 2: SECTION 1

Economic Systems

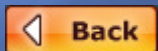
Three Economic Questions

- ▶ All nations in the world must decide how to answer three economic questions about the production and distribution of goods. (See Transparency 2-1.)
 - What goods will be produced?
 - How will the goods be produced?
 - For whom will the goods be produced?
- ▶ How a society answers these three economic questions defines its **economic system**.

TRANSPARENCY 2-1: Three Economic Questions

Every society must answer the following questions:

- ▶ **What** goods will be produced?
 - Because of scarcity, no country can produce every good it wants in the quantity it would like.
- ▶ **How** will the goods be produced?
 - ▶ Will production decisions be made by individuals or by the government?
 - ▶ Will producers use existing technology or new technology?
- ▶ **For whom** will the goods be produced?
 - ▶ Will the government decide? Will price decide?
 - ▶ Will goods be produced for the purpose of trade with other countries?



Two Major Economic Systems

- ▶ **Free enterprise** is an economic system in which individuals own all or most of the resources and control their use. Free enterprise is also known as capitalism or a market economy.
- ▶ **Socialism** is a different kind of economic system, in which the government may control or own many of the resources. Socialism is sometimes referred to as a command economy.

Differences Between Free Enterprise and Socialism

- ▶ In a free enterprise system, resources are owned and controlled by individuals. In socialism, these resources are controlled by the government. For example, in the former Soviet Union, the central government owned many of the resources in the country. Today, in North Korea, the government owns almost all of the resources in the country.
- ▶ The government plays a different role in each type of economy.

- ▶ In a free enterprise system, the government plays a small role in the economy. It does not make decisions about what goods and services will be produced or how they will be produced, and it allows prices to fluctuate.
- ▶ In a socialistic system, the government may make these decisions. Government decision makers control prices.

- ▶ Under socialism, government decision makers may write an **economic plan**, a plan that specifies the direction economic activities are to take. This plan may outline how many manufactured goods or agricultural goods are to be produced, and the prices that are to be charged for them.
- ▶ **Income distribution** refers to how all the income earned in a country is divided among different groups of income earners. Government decision makers under socialism are more likely to use the government's powers to redistribute income, usually directing it away from society's high earners.

- ▶ Does the United States operate under a free enterprise system or a socialist system? Under free enterprise people are allowed to own property, such as their house and land. Advocates of free enterprise believe that if something is owned by you alone, you are more likely to take care of it than if it were owned by you and others or owned by the government.
- ▶ A socialist view believes that it would be better for the government to own most of the nonlabor property in the economy, such as factories, raw materials, and machinery. Socialists believe that the government would be more likely than private individuals to make sure this property was used for the benefit of many instead of a few.

Mixed Economies

- ▶ Can every country's economy be easily categorized as either a free enterprise economy or a socialist economy? A country's economic system may contain some parts of free enterprise and socialism.
- ▶ For example, the United States is considered to have a free enterprise economic system. Most of the resources are owned by private individuals, and no overall economic plans determine the use of those resources. However, the U.S. government does control some prices.

- ▶ Economies with features of both free enterprise and socialism are called **mixed economies**. Most economies in the world are mixed economies. Mixed economies have different levels of economic freedom; some have more, others have less. Let's look at an example. (See Transparency 2-2.)

TRANSPARENCY 2-2: Index of Economic Freedom

Rank	Country	Index of Economic Freedom Score
1	Hong Kong	1.35
5	Ireland	1.70
10	Australia	1.79
12	United States	1.85
16	Canada	1.91
26	Italy	2.28
39	Japan	2.46
44	France	2.63
45	South Korea	2.64
63	Mexico	2.89
71	Thailand	2.98
90	Brazil	3.25
103	Egypt	3.38
112	China	3.46
118	India	3.53
124	Russia	3.56
137	Vietnam	3.83
149	Cuba	4.29
155	North Korea	5.00

Source: 2005 Index of Economic Freedom, a joint publication of the Wall Street Journal and Heritage Foundation.



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Traditional Economies

- ▶ Before free enterprise and socialist economies, many economies were **traditional economies**.
- ▶ A traditional economy is a system in which the answers to the three economic questions are based on customs, skills, and cultural beliefs. In a traditional economy, these customs, skills, and beliefs are passed on from one generation to the next.

- ▶ An example would be the old feudal system in Western Europe. Under the feudal system, all land was owned by a king. The king granted land to nobles, who in turn granted small plots of land to peasants to farm. The peasants kept part of what they produced; the remainder went to the nobles and, ultimately, to the king.
- ▶ Few traditional economies exist today. Most economies are mixed economies. Of course, the mixture of free enterprise and socialism often differs between nations.
- ▶ Will the mixture continue to change within a particular country as time goes on?

The Visions Behind Free Enterprise and Socialism

- ▶ A **vision** is a sense of looking at, understanding, and explaining how the world works.
- ▶ Adam Smith was an eighteenth-century economist whose ideas are fundamental to free enterprise. He believed that free enterprise is not only the economic system that produces the most goods and services, but that it is also the most ethical economic system.

- ▶ Smith felt that our self-interest prompts us to work hard, take risks, and in the end benefit others through our activities. Smith also believed that if people wanted to serve their own self-interest, they had to serve others first. According to Smith, we are led by an “invisible hand” to do good for others.

- ▶ Karl Marx was a nineteenth-century economist who pointed out what he believed to be many of the failures and injustices of free enterprise. His ideas are at the heart of socialism and communism. Marx did not see self-interest as leading to good things. Instead, he saw it as hurting others. Marx believed that capitalists, in pursuing their self-interests, actually exploited the workers.
- ▶ In his **labor theory of value**, Marx argued that all value in produced goods comes from labor. Therefore, the value of any item is determined by the necessary labor time needed to produce that item.

- ▶ The difference between the total value of production and the subsistence wages paid to workers defines the **surplus value**. For example, it takes 5 hours of labor time to produce a chair and 10 hours to produce a table, and this makes the table twice as valuable as the chair.
- ▶ According to Marx, this surplus value should go to the worker.