

Unit 2

Economic Systems: How Economies Are Organized

Economic System

- Society's way of coordinating the production and consumption of goods & services

Possible Goals of an Economic System

- **Economic freedom**
 - The ability to make our own economic decisions without interference from the government
 - A society that values economic freedom gives individuals & businesses the right to make decisions about how to use their resources
- **Economic efficiency**
 - Allocates resources in such a way that the greatest number of consumers get what they want with the least amount of waste
 - Strives for full employment because unemployed workers are a wasted resource

- **Economic equity**
 - Society seeks a “fair” and “just” distribution of a society’s wealth
 - “Fair” and “just” are very vague and subjective terms
 - One person’s “fair” may not be the same as another person’s “fair”
- **Economic growth**
 - Economy produces more and better goods & services
 - Over time, this leads to a higher standard of living
 - Key element is scientific & technological innovation

- **Economic security**
 - Provide the less fortunate in society with the support they need in terms of food, shelter, & health care to live decently
- **Economic stability**
 - Eliminate economic uncertainty
 - Goods & services we want are there when we want them
 - Our jobs are there when we go to work each day
 - Prices are predictable, allowing us to plan ahead for purchases

All societies pursue most or all these goals to varying degrees.

Basic Economic Questions

- All economic systems seek their economic goals by who in the economy makes the decisions on the following economic questions:
 - **What to produce?**
 - What goods & services will be produced in that economy?
 - **How to produce?**
 - How will the productive resources in the economy be used to produce the goods & services?
 - **For whom to produce?**
 - Who in society will have access to the results of the production?

How To Produce = How To Organize the Productive Resources

- Productive resources are normally referred to as the factors of production
- These are the inputs that go into the production of goods & services that will satisfy the economic wants of the society

- **Natural Resources**
 - Sometimes referred to by the generic term land
 - The “gifts of nature”
 - Perpetual resources
 - Widely available and in no danger of being used up
 - Land, sunlight, wind, etc.
 - Renewable resources
 - Can be replaced as they are used
 - Forests, plants/crops, fresh water, fish, livestock, etc.
 - Non-renewable resources
 - Once used, they are gone forever
 - Oil, coal, natural gas, etc.
 - Value of natural resources depends on someone knowing how to plug them into the production process.

- **Human Resources**
 - Sometimes referred to as labor
 - The time & effort people devote to producing goods & services in exchange for pay (wages)
 - Can be physical labor
 - Can be mental activity
 - Quantity of labor available depends on the size of its population and the people's willingness to work
 - Quality of labor depends on how skilled those workers are
 - Called ***human capital***

- **Capital Resources**

- **Physical Capital**

- Also called ***capital goods***
 - Tools, machinery, factory buildings, inventories, etc. used to produce the final products

- **Financial Capital**

- The money that is invested in businesses to produce future wealth
 - Money can be used to:
 - Purchase capital goods
 - Pay employees
 - Pay other expenses (rent, utilities, insurance, advertising, etc.)
 - Needed to start and run business before first sale of product ever takes place (comes from investment and/or loans)
 - Needed as business operates (comes from sales, loans, and/or investments in the business)

Productivity

- A measure of the output per unit of input
- How measured:

OUTPUT

INPUT

- Businesses want to arrange their productive resources to maximize productivity
 - Must decide how much land, labor, and physical capital to use to produce its product

Your Factory Makes Books

- Materials (natural resources)
 - paper & paper clips
 - costs \$.25 per book
- Human Resources
 - workers (you)
 - cost \$1.00 per worker per day
- Capital Resources
 - factory (desks): rent is \$2.00 per day
 - equipment (pen): lease is \$.50 per day

Round 1: Everybody Does the Same Thing

- All workers perform all steps to make book
 - fold/tear
 - paper clip
 - write
- Each factory only has 1 pen/pencil.
- You will have **3** minutes to make as many books as you can.

Round 2: Reorganize Production

- Teams may reorganize their work force in any way they wish
- Each factory may lease as many additional pens/pencils as they wish.
 - Costs an additional \$.50 per pen/pencil
 - Increases production costs.
- You will have **3** minutes to make as many books as you can.

Round 3: Reorganize Production Again

- Teams may reorganize their work force in any way they wish
- Each factory may lease as many additional pens/pencils as they wish.
 - Costs an additional \$.50 per pen/pencil
 - Increases production costs.
- You will have **3** minutes to make as many books as you can.

What Defines an Economic System?

- Economic systems are defined by who answers the 3 basic economic questions, and how they answer those questions
- Usually also emphasize different economic goals

Traditional Economies

- Answers to basic economic questions determined by custom
 - ***What to produce*** in economy determined by societal customs
 - ***How to produce*** also driven by societal customs
 - ***For whom to produce*** also driven by societal custom
- Primary economic goals:
 - Economic Stability
 - Economic Security

Market Economies

- Answers to basic economic questions determined by individuals in the marketplace
 - ***What to Produce*** determined by consumers through what they demand in the marketplace
 - Producers only continue to produce what consumers continue to demand
 - If consumers no longer want it, producers will no longer produce it
 - Referred to as ***consumer sovereignty***

- ***How to Produce*** determined by producers seeking to maximize productivity & profit
 - Seeks to use mix of natural resources, human resources, & capital resources that minimizes necessary cost per unit of output
 - Choices of mix are driven by what potential customers they want to appeal to
- ***For Whom to Produce*** determined by the price of the product
 - Consumer can buy whatever he/she wants, as long as he/she has the money to buy it
- Primary economic goals:
 - Economic Freedom
 - Economic Efficiency

Command Economies

- Answers to basic economic questions determined by those in charge
- Original command economies were controlled by powerful rulers
 - Kings, pharaohs, emperors
 - Primary economic goals:
 - Accumulate wealth and goods for the ruling class
 - Economic Stability for those in the working class

- Modern command economies use central planning by the state to answer the 3 basic economic questions
 - ***What to Produce, How to Produce, & For Whom to Produce*** all determined by government committees of economists, production experts, and political officials
 - They decide what goods and services should be produced
 - They decide which farms and factories should get which resources to produce what was planned
 - They control prices and wages and decide how goods & services should be distributed
 - Primary economic goals:
 - Economic Equity
 - Economic Security

Mixed Economies

- No economy is a true free-market economy
 - Governments all exert some degree of influence on economic activity
- No economy is a true command economy
 - Still permit a limited amount of market activity
- No economy is a true traditional economy
 - Market influences have crept into these systems
 - Governments exert some influence on how these economies operate
- These types of economies are theoretical extremes
 - Economies fall somewhere between these extremes
- Every nation forges its own balance between market freedom and government involvement

Government's Role in a Mixed Economy

- At very least, governments are needed to establish the institutions that enable markets to operate
 - Legal system to enforce laws
 - Stable system of currency

- Protection & Regulation
 - Governments take actions to protect their citizens from the potential dangers of the economic activities by businesses
 - Examples:
 - Child labor laws
 - Pollution regulation
 - Workplace safety regulation
 - Regulation of banks & other financial institutions

- Government provides for ***public goods***
 - ***Public good*** – An item, once provided, is available to all without further opportunity cost
 - Those who don't pay for good cannot be excluded from using it
 - “Free rider” problem
 - Free rider gets benefits without paying the costs
 - Private markets won't provide a good that people don't pay for
 - Examples:
 - Roads
 - Highways
 - Bridges

The Mixed Economy Continuum: From Free to Repressed

- The “mix” of market freedom & government control varies greatly from one nation to the other
- Countries can be evaluated based on the amount of economic freedom they afford their citizens in their country

Criteria Evaluated to Determine Economic Freedom of a Country

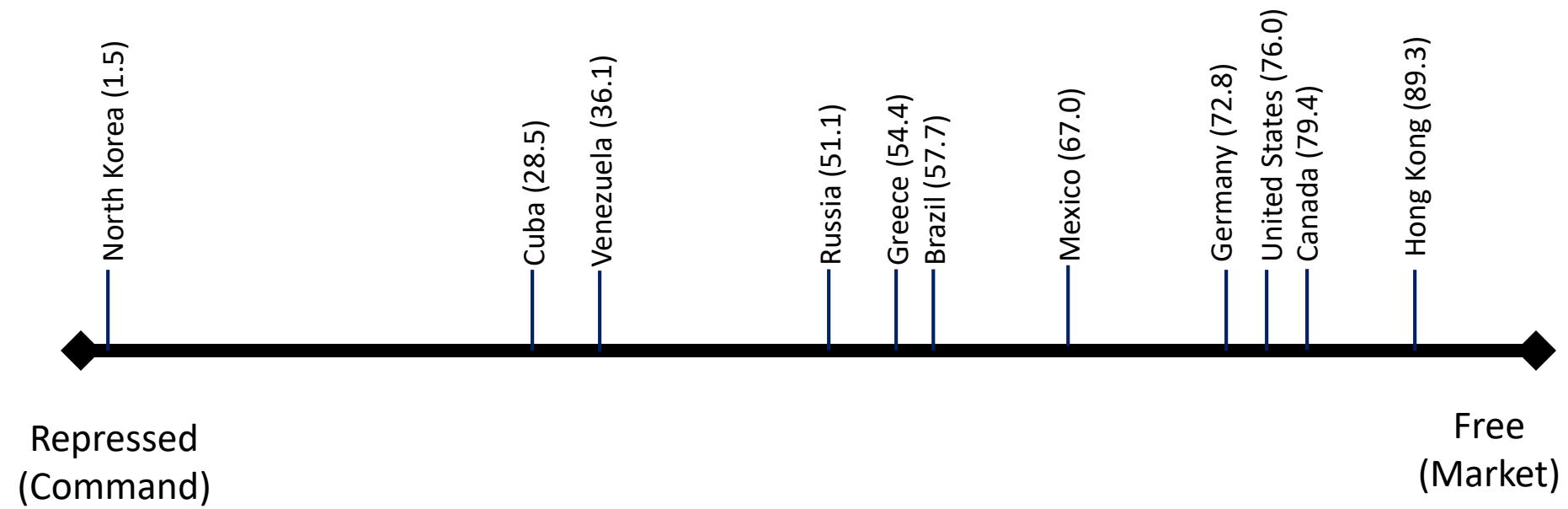
- Rule of Law
 - Property Rights
 - Does that country have a legal system that can be relied on to enforce the property rights of its citizens?
 - Does that country have a legal system that can be relied on to enforce the contract rights of its citizens?
 - Freedom from Corruption
 - Does that country effectively deal with government corruption?
 - Does that country have a legal system that will protect businesses from having to pay bribes to government officials in order to be able to operate in that country?

- Limited Government
 - Government Spending
 - What level of the country's output is taken up by government spending?
 - To what extent is the government burdening its population with debt, the repayment of which (including interest payments) will be a drain on future economic activity?
 - Fiscal Freedom
 - Does the government take a large percentage of income earned by individuals and businesses in the form of income taxes?
 - Does the government take a large percentage of income earned from investments made by individuals and businesses?

- Regulatory Efficiency
 - Business Freedom
 - How hard is it for a business to start and operate in terms of government regulations with which it must comply?
 - Labor Freedom
 - To what extent does the government's laws concerning labor support the ability of employers and employees to come to mutually agreeable terms concerning wages, working conditions, etc.?
 - Monetary Efficiency
 - Is the country's money supply stable, allowing for predictability in pricing for its businesses and individual citizens?

- Open Markets
 - Trade Freedom
 - Can businesses in the country trade freely with other countries?
 - What types of trade barriers does the country have that prevent businesses from being able to trade with other countries?
 - Investment Freedom
 - How open is the country to foreign investment?
 - Financial Freedom
 - How effective is its financial sector in connecting individuals and businesses with sources of financial capital for personal and business use?
 - How risky is its banking sector?

2013 Country Rankings Based on the Heritage Foundation's Index of Economic Freedom



*Country rankings & criteria for the Index of Economic Freedom courtesy
Heritage Foundation www.heritage.org/index*