

Answering the Three Economic Questions

Preview

Objectives

After studying this section you will be able to:

1. **Identify** the three key economic questions of what to produce, how to produce, and who consumes what is produced.
2. **Summarize** the basic economic goals societies share.
3. **Compare and contrast** the four economic systems: traditional economy, market economy, centrally planned economy, and mixed economy.

Section Focus

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.

Key Terms

economic system
factor payments
safety net
standard of living
traditional economy
market economy
centrally planned economy
mixed economy

In Chapter 1, you read about the economic concept of scarcity—that we cannot have all that we want or need. Indeed, in some places in the world, people cannot even meet their basic needs for food, clothing, and shelter because their resources are too scarce. Scarcity forces societies and nations to answer some hard economic questions. Different economic systems have evolved in response to the problem of scarcity. An **economic system** is the method used by a society to produce and distribute goods and services. Which economic system a society employs depends on that society's goals and values.

Three Key Economic Questions

Because economic resources are limited, every society must answer three key economic questions:

- What goods and services should be produced?
- How should these goods and services be produced?
- Who consumes these goods and services?

What Goods and Services Should Be Produced?

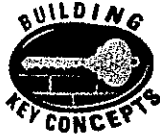
Each society must decide what to produce in order to satisfy its needs and wants. In today's complex societies, it is often difficult to distinguish between needs and wants. While it may be obvious that we need food and shelter, modern societies face additional important considerations. How much of our resources should we devote to national defense, education, public health and welfare, or consumer goods? Which consumer goods should we produce?

Recall the guns-and-butter trade-off described in Chapter 1. Because of our limited resources, each production decision that a society makes comes at an opportunity cost.

How Should Goods and Services Be Produced?

The next question we face is how to use our resources to produce goods and services. For example, should we produce electricity with oil, solar power, or nuclear power? Should teachers have classes of 20 students or 50 students? Should we produce food on large corporate farms or small family farms?

economic system the method used by a society to produce and distribute goods and services

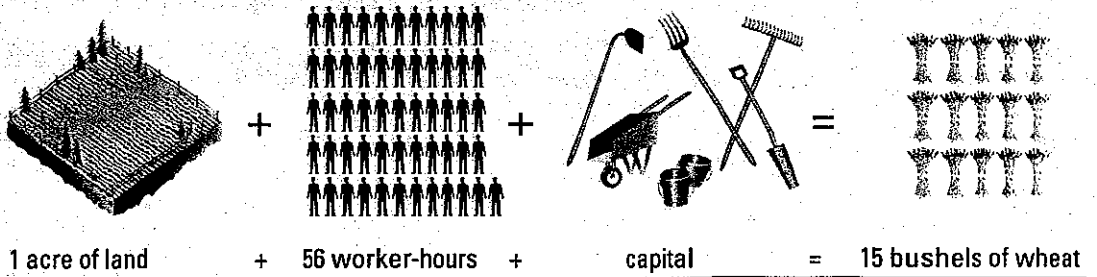


Today, capital— not labor—dominates the answer to how wheat is produced.

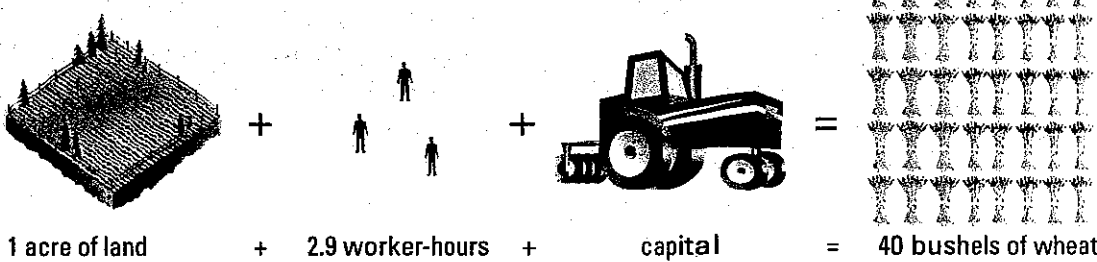
Opportunity Cost
Identify the opportunity costs of each method of farming.

Figure 2.1 Combining Factor Resources

Hand tools



Modern mechanical equipment



factor payments the income people receive for supplying factors of production, such as land, labor, or capital

Although there are countless ways to create all of the things we want and need, all require land, labor, and capital. These factors of production can be combined in different ways. For example, examine the chart above (Figure 2.1). Before the introduction of modern farming equipment, a typical combination of resources for producing 15 bushels of wheat was 56 hours of labor, 1 acre of land, and simple hand tools. With today's mechanical farming equipment, farming is much more efficient. Forty bushels of wheat can be harvested from one acre of land with just 2.9 worker-hours of labor.

Who Consumes Goods and Services?

By the end of the 1990s, the top 25 goods manufacturers in the United States were launching an average of 13 new products every day. Retail stores, which 50 years ago typically carried about 3,000 items, now offer about 30,000 different products. American farms produce 315 million metric tons of wheat, rice, and corn and maintain about 180 million head of livestock. Despite this staggering output, quantities are not unlimited.

So how does this abundance get divided up? Who gets to drive a new luxury car and who can only afford a subway pass? Who gets to attend a concert, and who stays home? Who eats a well-balanced diet and who eats nothing but hot dogs for every meal? Who gets access to a good education? Societies must decide how to distribute the goods and services they generate.

The question of who gets to consume which goods and services lies at the very heart of the differences between economic systems today. Each society answers the question of distribution based on its unique combination of social values and goals.

Economic Goals

Different societies answer the three economic questions based on the importance they attach to various economic goals. (Figure 2.2 lists some general economic goals that most economic systems try to address.) Bear in mind that societies pursue each of these goals, to some degree, at the expense of the others.

Economic Efficiency

Because resources are always scarce—that is, they always involve an opportunity cost—most societies try to maximize what they can get for the resources they have to work with. If a society can accurately assess what to produce, it increases its economic efficiency. A manufacturer would be wasting resources producing record albums if people prefer to buy CDs. Knowing the best way to produce a product cuts waste, too. Of course, in the end, products need to reach consumers. An economy that can't deliver goods isn't efficient.

Economic Freedom

Most of us value the opportunity to make our own choices. How do you feel about laws that keep you from earning an income? What about laws that forbid you to make certain purchases or possess certain items? People all over the world face limitations on economic freedom.

Governments intervene in the economic activities of their citizens, resulting in limits on economic freedom. Child labor laws prohibit young children from earning an income. Substance control laws place limits on what can be purchased and by whom. The federal minimum wage dictates to employers the lowest wage they may pay employees. The economic systems of different nations allow different degrees of economic freedom.

Economic Security and Predictability

Most people don't like uncertainty. We want to know that we can get milk and bread every time we go to the grocery store,

THE WALL STREET JOURNAL

CLASSROOM EDITION

In the News As this excerpt from a Wall Street Journal Classroom Edition article shows, the Federal Emergency Management Agency (FEMA) provides economic security in the form of disaster relief.

"From 1989 to 1998, the Federal Emergency management Agency spent \$7.4 billion for earthquake relief. In the past 10 years, two huge quakes shook California: one in the San Francisco Bay area in 1989, and the other in Northridge, Calif., in 1994. FEMA paid out \$6.5 billion for Northridge alone."



This family (left) will need to rebuild their home after a devastating hurricane. Government Which economic goal could help them recover from the storm?



Figure 2.2 Economic Goals

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

safety net government programs that protect people experiencing unfavorable economic conditions

standard of living level of economic prosperity

traditional economy economic system that relies on habit, custom, or ritual to decide questions of production and consumption of goods and services

▼ The traditional economy of Guatemala's Quiché Maya includes regular market days.

or that the gas pumps will be full when we go to gas up our cars. We want to feel confident that we will get our paychecks every payday. Ideally, economic systems reassure people that goods and services will be available when they need them and that they can count on receiving expected payments on time.

We also want the security of knowing that help is available if we are elderly, poor, unemployed, or facing some other potential economic disadvantage. Most people feel that the government should provide some kind of **safety net**, or set of government programs that protect people experiencing unfavorable economic conditions. These include injuries, layoffs, natural disasters, or severe shortages. Most countries also believe in providing some sort of base income for retired persons to ensure that older people can support themselves after retirement.

Economic Equity

Each society must decide the best way to divide its economic pie. What constitutes a fair share? Should everyone get the same, or should one's consumption depend on how much one produces? How much should society provide for those who are unable or unwilling to produce?

Many people believe in equal pay for equal work. Not all jobs are equally valued by society, however. Most lawyers earn

more than **most** nurses. Most computer programmers earn more than most truck drivers. In **addition**, not everyone is able to work. How should we provide for the ill and infirm?

Economic Growth and Innovation

A nation's **economy** must grow for a nation to improve its **standard of living**, or level of economic prosperity. This is especially true if a country's population is growing. The economy also must grow to provide new jobs and income for people.

Innovation plays a huge role in economic growth. Think of the changes brought about by the shift from nomadism to agriculture, from the agricultural age to the industrial age, from the industrial age to the information age. Innovations in technology increase the efficiency of production and usher in new goods and services. In your lifetime, you are witnessing innovations in computer and networking technology that are changing the ways people work, shop, conduct business, locate information, and communicate.

Additional Goals

A society may value goals in addition to the basic ones described above. Environmental protection, full employment, universal medical care, and other important concerns may be among a nation's chief economic goals.

All nations must prioritize their economic goals, or arrange them in order of importance. No matter how a nation prioritizes its goals, one fact remains: achieving any economic goal comes only with some kind of economic trade-off.

Four Economic Systems

Four different economic systems have developed to address the three key economic questions. Each system reflects a different prioritization of economic goals.

Traditional Economies

A **traditional economy** relies on habit, custom, or ritual to decide what to



produce, how to produce it, and to whom to distribute it. There is little room for innovation or change. The traditional economic system revolves around the family. Work tends to be divided along gender lines. Boys tend to take up the occupations of their fathers, while girls follow in the footsteps of their mothers.

Traditional economies are usually communities that tend to stay relatively small and close. Often these societies work to support entire groups, rather than just themselves or their immediate families. Agricultural and hunting practices usually lie at the very heart of the people's lives, laws, and religious beliefs.

Societies with traditional economies have few mechanisms in place to deal effectively with the effects of environmental disaster, such as a flood or drought. They also tend to remain stagnant, resisting change at both the individual and community level. They may be slow to adopt new technology or radical new ideas. They may not have access to goods you see every day at the grocery store. In most cases, these communities lack modern conveniences and have a low standard of living.

Market Economies

In a **market economy**, economic decisions are made by individuals and are based on exchange, or trade. The choices made by individuals determine what gets made and how, as well as who consumes the goods and services produced. Market economies are also called free markets, or capitalism. You will read about the free market in detail in Section 2.

Centrally Planned Economies

In a **centrally planned economy**, the central government alone decides how to answer all three key economic questions. Centrally planned economies are sometimes called command economies, because a central authority is in command of the economy. Section 3 discusses the theories behind centrally planned economies.

Mixed Economies

Most modern economies are **mixed economies**—a combination of traditional, market, and centrally planned economies. Section 4 describes the reasons for mixed economies and the various ways government is involved in such economies.

market economy
economic system in which decisions on production and consumption of goods and services are based on voluntary exchange in markets

centrally planned economy
economic system in which the central government makes all decisions on the production and consumption of goods and services

mixed economy
economic system that combines tradition and the free market with limited government involvement