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Chapter 2
Economic Decision Making & Economic Systems

CHAPTER OBJECTIVES

1. Introduce the basic economic decisions that must be made in every society because of scarcity and how those decisions are made in various economic systems.
2. Explain the basic philosophy, structure, and operation of a market economy and its strengths and weaknesses.
3. Describe how economic decisions are made in a planned economy and its strengths and weaknesses.
4. Explain mixed economies and some of the changes in the world's planned economies.
5. Consider how the U.S. economic system was influenced by its British foundations and major periods in U.S. history.

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STUDY ORGANIZER

1. Identify the three basic economic decisions that must be made in every society.
2. Differentiate among traditional, market, planned, and mixed economies.
3. Explain and illustrate the operation of the circular flow model, including real and money flows, and input and output markets.
4. Explain, using the circular flow model, how the three basic economic decisions are made in a market economy.
5. Understand how economic decisions are made in a planned economy.
6. Identify some strengths and weaknesses of market and planned economies.
7. Identify where, and give some examples of how, government intervenes in a mixed economy.
8. Differentiate among capitalism and socialism.
9. Identify and explain the British foundations of U.S. capitalism.
10. Recognize the importance of Adam Smith and *The Wealth of Nations* in the development of capitalism.
11. Appreciate the positive and negative aspects of the British Industrial Revolution.
12. Identify the historical turning points in the movement of the U.S. economy away from laissez-faire capitalism toward a mixed system.

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13. Understand the roles of the U.S. industrial boom, the New Deal, the Employment Act of 1946, and more recent regulatory and federal budget developments in bringing U.S. capitalism to its present form.

TEACHING CHAPTER TWO

This chapter focuses on two areas: the basic economic decisions and economic systems and the development of the U.S. economic system. Chapter Two is essentially nontheoretical and gives some institutional and historical depth for understanding the operation of the U.S. economy. This chapter begins by extending the problem of scarcity to the basic economic questions or decisions. How the basic questions are answered is tied, in turn, to various economic systems. A traditional, market, planned, and mixed economy are then defined and explained. The last section of the chapter is devoted to the U.S. economy.

In teaching the material in this chapter, an instructor might stress choice in various economic systems. Students are often unaware of decision making in anything but a market environment and are usually very interested in the operation of other economic systems. There are several opportunities in the chapter to consider why and how economic systems develop and change. Application 2.2, Review Questions 5 and 6, Discussion Questions 1, 4, and 5, and the Critical Thinking Case can all be related to these questions.

The operation of a market economy is fully developed in this chapter with the aid of a circular flow model. Use of the circular flow should be helpful in a classroom lecture and/or discussion of a market economy. The treatment of a mixed economy focuses on the U.S. experience, and provides an excellent background for a discussion of whether or not the current degree of government intervention in the economy is appropriate. The material from the section, "The U.S. Economic System," provides added depth for a debate on the role and future trend of government intervention.

It is suggested that the last section of Chapter Two *not* be eliminated, although it is historical in nature. The subsection, "The British Foundations of the U.S. Economy," provides the basis for an understanding of the development of capitalism in general and covers mercantilism, the contributions of Adam Smith, and the British Industrial Revolution. The subsection, "Historical Highlights in the Development of the U.S. Economy," offers a foundation and some continuity with the past for understanding and evaluating current economic problems. Also, it might be noted that the material in this section, when taught by both of the authors, generated a great deal of student interest. The poem in Application 2.3 always elicits student comments.

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TEACHING OUTLINE

The following outline is based on the major sections, sub-sections, and applications in this chapter. It indicates where the review questions, discussion questions, *Study Guide* exercises, Test Your Understanding, Applications, Critical Thinking Case, and Up for Debates might best be used.

I. SCARCITY, THE BASIC ECONOMIC DECISIONS, AND ECONOMIC SYSTEMS
LO: Introduce the basic economic decisions that must be made in every society because of scarcity and how those decisions are made in various economic systems.

A. Economic Systems and the Basic Economic Decisions
* Review Questions 1 and 2.
* Discussion Questions 1, 2, and 9.
B. Traditional Economies
C. Economic Decisions in a Traditional Economy

II. MARKET ECONOMIES
LO: Explain mixed economies and some of the changes in the world's planned economies.
* Critical Thinking Case 2 "Judging Economies"

A. The Operation of a Market Economy
* Review Question 4.
* Study Guide Exercise: The Circular Flow Model 1.
B. Economic Decisions in a Market Economy
1. What to Produce?
a. Application 2.1, "Saying No!"
2. How to Produce?
3. Who Gets Goods And Services?
C. Evaluating Market Economies
* Review Question 5.
* Discussion Question 3.
1. Strengths: Efficiency, Consumer Choice, and the Opportunity for Success
2. Weaknesses: Market Power, Equity, and Information
D. Government Intervention in a Market Economy: A Mixed Economy

III. PLANNED ECONOMIES
LO: Describe how economic decisions are made in a planned economy and its strengths and weaknesses.

A. Economic Decisions in a Planned Economy
B. Evaluating Planned Economies

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*Review Question 6.

IV. MIXED ECONOMIES
LO: Explain mixed economies and some of the changes in the world's planned economies.
* UP FOR DEBATE "Are U.S. and Western European Economic Institutions Appropriate for Other Nations?"
*Review Question 3.
A. Test Your Understanding: Economic Decision Making and the Circular Flow
B. Changing Economic Systems
* Discussion Questions 4 and 5.
A. The Realities of Economic Change
B. Application 2.2 "The People's Republic of China"

V. THE U.S. ECONOMIC SYSTEM
LO: Consider how the U.S. economic system was influenced by its British foundations and major periods in U.S. history.
* Study Guide Exercise: U.S. Economic Development 1.
A. The British Foundations of the U.S. Economy
* Review Question 7.
1. The Rise of Economic Individualism
* Discussion Question 6.
2. The British Industrial Revolution, 1750-1850
3. Application 2.3, "The Factory Girl's Last Day"
B. Historical Highlights in the Development of the U.S. Economy
* Review Question 8.
* Discussion Question 7.
1. The Industrial Boom
2. The New Deal and World War II Era
3. The Regulatory and Deregulatory Waves
4. Recent Developments
* Discussion Question 8.

SUGGESTED ANSWERS TO REVIEW QUESTIONS

1. What are the three basic decisions every economy must make? Why must these decisions be made?
The three basic economic decisions are:
* what goods and services to produce and in what quantities?
* how to produce these goods and services?

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* who gets the goods and services?
These decisions must be made in every economy because of the scarcity of resources.

2. How do market, planned, and mixed economies make the three basic economic decisions?
In a market economy, the basic economic choices are made through the interactions of individual buyers and sellers in the marketplace.

In a planned economy, the choices are made by the planners who are either associated with the government or are in some other way representative of the members of the society.

In a mixed economy, the choices are made by a combination of planning and individual decision making.

3. Draw a simple circular flow diagram to illustrate the structure of a market economy. Include businesses and households, input and output markets, and real and money flows.
See Figure 2.2 and Figure 2.3 in the text.

4. Below are seven activities. Indicate whether each one is: a real flow through a product market, a money flow through a product market, a real flow through a resource market, or a money flow through a resource market
a. Receiving a paycheck at the end of each month
b. Delivering a specially ordered hybrid car to a buyer
c. Receiving patient care in a hospital
d. Using a credit card to buy a meal in a restaurant
e. Earning profit over the summer from your own ice cream stand
f. Obtaining college credits
g. Working overtime
a. money flow through a resource market
b. real flow through a product market
c. real flow through a product market
d. money flow through a product market
e. money flow through a resource market
f. real flow through a product market
g. real flow through a resource market

5. Identify three strengths of a market economy. Define and give a current example of a market failure.
Strengths of a market economy are:
* strong efficiency incentives,

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* price allows direct signals between buyers and sellers
* economic freedom
* wide selection of goods and services
* incentives for innovation and growth.
* choices/prices of goods and services reflect buyers' and sellers' values and priorities

Weaknesses of a market economy are:
* no protection for people without marketable skills
* nothing to ensure that all people get adequate goods and services
* market power in the hands of a few sellers
* nothing to protect people with inadequate knowledge to make informed market decisions
* few incentives to protect the environment
* age, race, or gender discrimination

A market failure occurs when the market system creates a problem for society or when it fails to achieve a societal goal. Examples of market failure include insufficient public goods, pollution, and inadequate access to basic goods and services, such as food and health care.

6. Identify the strengths and weaknesses of a planned economy. Explain what we mean by planning failure.
Strengths of a planned economy are:
* ability to accomplish goals quickly
* unemployment is easier to eliminate
* the distribution of goods and services may be modified to achieve equity

Weaknesses of a planned economy are:
* failure to fulfill consumers' wants and needs;
* bottlenecks, shortages, and stoppages due to the complexity of the planning process
* few incentives for producers or workers
* ignoring long-term consequences to the environment

Planning failure results when centralized planning creates a problem for society or fails to achieve society's goals. Examples of planning failure include overproduction of some goods and underproduction of others, inferior products, and pollution.

7. What is the invisible hand doctrine and why is it important for laissez-faire capitalism? How are the British Industrial Revolution and the U.S. industrial boom similar? According to the invisible hand doctrine, people carry on their business in a way that serves their own best interests. Therefore, since it is personally advantageous for the seller to give the buyer what he or she wants, the seller will do so. Thus, as laissez-faire capitalism states, it is not necessary for

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the government to intervene in the market. The British experience with industrialization is important because it served as a model for the U.S. economic system.

8. Indicate whether, and explain why, each of the following moved the U.S. economy closer to, or further from, laissez-faire capitalism.
a. The Sherman Antitrust Act of 1890 and the Meat Inspection Act of 1907
b. The New Deal programs of the 1930s
c. World War II programs
d. Health care legislation during the Obama administration
a. The Sherman Antitrust Act of 1890 and the Meat Inspection Act moved the U.S. economy further from laissez-faire capitalism because these acts imposed standards and regulations on producers.
b. The New Deal programs moved the U.S. economy further from laissez-faire capitalism because these programs involved the government in job creation, providing income for some, and in banking and finance decisions.
c. World War II programs brought government planning to production, human resources, wages, and prices. These moved the economy further from laissez-faire capitalism. Most of these programs were dismantled at the end of the war.
d. The health care legislation (i.e., the Affordable Care Act) will move the economy further from laissez-faire capitalism because more regulations will be imposed on businesses, insurance companies, and health care markets.

SUGGESTED ANSWERS TO DISCUSSION QUESTIONS

1. Suppose that you have been chosen to be on a blue-ribbon panel of experts to determine how well or poorly the economies of the world are operating. Your task is to come up with a checklist of five criteria by which different economies can be judged. Which five factors would you pick as criteria? Why?
Factors will vary depending on one's values. Factors to consider:
* income per capita
* employment rate
* household satisfaction
* business satisfaction
* government's role in the economy
* societal issues such as health care, discrimination, the environment, and welfare of all citizens
* freedom of choice

2. What considerations might cause one nation to choose to operate as a market economy and another as a planned economy?

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A nation may choose to operate as a market economy if society attaches more importance to individual decision making. A nation may choose to operate as a planned economy if society places more importance on the collective good.

3. Many people today are asking what the U.S. government should do when people who need health care cannot afford it. Is less-than-universal access to health care an example of a market system allocating scarce resources efficiently, or is it an example of market failure? Can it be both?

Less-than-universal health care can be used as an example of market failure. Persons with access to health care benefit but persons without adequate care suffer. By not allocating relatively inexpensive resources for preventative care upfront, the economy is later forced to use more expensive resources to treat critically ill persons. This is an inefficient use of scarce medical resources and dollars. Should access to health care be controlled by the government? It depends on the degree of government intervention society wants and whether or not the government intervention would improve the operation of the market.

4. This chapter illustrates how economic systems change over time. What forces might lead to the evolution of an economic system, and how would these forces cause an economy to change?

Forces that lead to the evolution of an economic system are:

* changes in the economic structure from agriculture to industry
* changes in the structure of society
* changes in technology

These forces cause an economy to change because the economy answers the three basic economic questions differently than before.

5. Do you think that China will someday have an economic system that leans more toward laissez-faire capitalism than the U.S. economy?

Possible obstacles involved in moving China from a planned economy to a market economy are:

* privatization of resources that were once collectively owned
* society's ability to adapt to individual rather than collective decision making
* a shortage of professionals to facilitate the transition
* a shortage of goods and services leading to inflation
* unemployment

6. Would mercantilism, the economic system that was important in Europe in the seventeenth and eighteenth centuries, be most consistent with a market economy, a planned economy, or a mixed economy? Do you know of any economic activity occurring at the present time that reflects a mercantilist philosophy?

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Mercantilism would be most consistent with a planned economy because both systems feel the state is the best judge of what is good for the economy. Government intervention in an economy can be described as mercantilistic. For example, the government often sets policies designed to increase U.S. exports.

7. Based on your general knowledge of U.S. history and current events, how active a role do you think government will be playing in the economy 20 years from now compared to the role it plays today?
Student opinions will vary.

8. Environmental concerns are increasingly global as we realize that the careless use of the world's resources influences the entire globe. The impact of global warming, excessive energy use, and polluting rivers and streams is not confined to any one nation. What type of economic system do you think would best address environmental concerns? Will global concerns push more nations toward similar systems?
One of the strengths of a planned economy is the ability to accomplish social goals quickly. However, a weakness of a planned economy is that there are few incentives to protect the environment. One might argue that a planned economy could address environmental concerns well because efforts could be centrally organized and implemented, and coordination could be facilitated across nations. In reality, though, an incentive system in a market economy might be superior than efforts by a planned economy because individuals and businesses could be motivated to use resources more wisely. A mixed economy might offer the best option for addressing environmental concerns because government could define limits on environmental degradation, while at the same time, efficiency would be encouraged.

9. Chapter 1 introduced the importance of efficiency and equity as they affect economic decisions. Discuss how each of the three basic decisions are related to efficiency and equity.
The choices of what goods and services to produce and how to produce the goods and services should be based primarily on efficiency. By basing these choices on efficiency, an economy will produce the maximum possible amount of the goods and services it most prefers. The distribution of goods and services should be based primarily on equity.

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Chapter 2 EOC questions

Discussion Questions

1. Many people today are asking what the U.S. government should do when people who need health care cannot afford it. Is lack of access to health care an example of a market system allocating scarce resources efficiently, or is it an example of market failure? Can it be both?

   Section Reference: Scarcity, The Basic Economic Decisions, and Economic Systems
   Learning Objective: 2.1 Introduce the basic economic decisions that must be made in every society because of scarcity and how those decisions are made in various economic systems.
   Difficulty Level: Medium
   Bloom's Level: Application

2. Do you think that China will someday have an economic system that leaves more toward laisse-faire capitalism than the U.S. economy?

   Section Reference: Mixed Economies
   Learning Objective: 2.4 Explain mixed economies and some of the changes in the world's planned economies.
   Difficulty Level: Medium
   Bloom's Level: Application

3. Environmental concerns are increasingly global as we realize that the careless use of the world's resources influences the entire globe. The impact of global warming, excessive energy use, and polluting rivers and streams is not confined to any one nation. What type of economic system do you think would best address environmental concerns? Will global concerns push more nations toward similar systems?

   Section Reference: Scarcity, The Basic Economic Decisions, and Economic Systems
   Learning Objective: 2.1 Introduce the basic economic decisions that must be made in every society because of scarcity and how those decisions are made in various economic systems.
   Difficulty Level: Medium
   Bloom's Level: Application

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