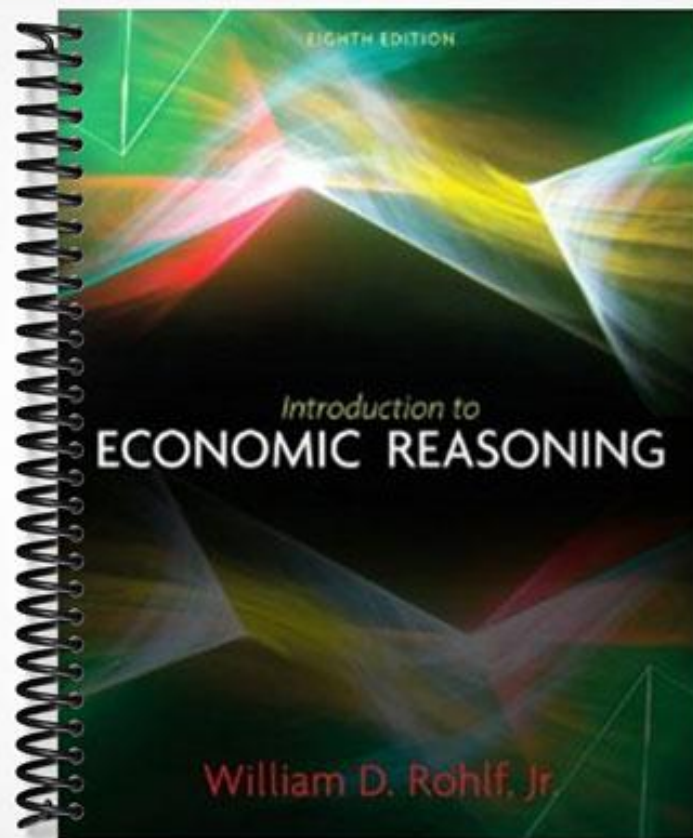


SOLUTIONS MANUAL



Chapter 2

Economic Systems

■ Content and Teaching Tips

The purpose of this chapter is to introduce the concept of an economic system and convince students that all economic systems share some common features while also differing in significant ways.

The chapter begins by suggesting that all economic systems can be identified according to (1) who owns the means of production, and (2) who makes the economic choices that determine what, how, and for whom to produce. I have found it productive to spend some time talking about each of these elements before moving on to the discussion of the models contained in the chapter. For instance, you can ask the students to describe ownership of the means of production in the United States. This will invariably lead to a discussion of public versus private ownership.

The section on the model of pure capitalism is easily understood by most students and provides a good opportunity to reinforce the concept of a model. I want students to understand that economists use models to make sense out of the real world. For that reason, I pause frequently to remind students that we are working with a model.

The circular flow model usually presents problems for some students in the class. Students have preconceived ideas of what is meant by a “market,” and those ideas make it difficult for them to make sense out of the circular flow diagram. It pays to go slow and emphasize that a market is not a place, but rather consists of all buyers and sellers of a particular item. One useful exercise (once students seem comfortable with the flow model) is to reverse the position of households and businesses and ask students to explain the consequences of that simple change. This can be done as a homework assignment, so it need not take class time.

Because students are not familiar with economic systems other than their own, they tend to be particularly interested in the model of pure command socialism. It is important to point out, again, that this is an economic model, not a description of the economic system in China or Cuba or the former Soviet Union. As you work through the elements of command socialism, you can reinforce the students’ understanding of the model of pure capitalism by asking them to compare the two models. For instance, command socialism is characterized by highly centralized decision making. How does that compare to decision making under pure capitalism? Or, ask the students to explain who does the economic planning in pure capitalism.

The section on mixed economies is intended to convince students that, while all economic systems are blends of pure capitalism and pure command socialism, they each retain a distinctive “personality.” In addition, I’d like students to recognize that altering the mix of private and public ownership and the degree of centralized decision making is slow going, and the result is tough to predict. Comparing the U.S. economy to those of Germany and Sweden and Japan can help with the first objective and can lead to some interesting discussion regarding the role of government. The **Economic Reasoning** selection “In Hard Times, Russia Moves in To Reclaim Private Industries” (see Page 54 in the textbook), should help with the second. It also illustrates that not everyone in the economy may be interested in, or supportive of, change.

■ Answers to the Questions Accompanying “Use Your Economic Reasoning” Selections

“In Hard Times, Russia Moves in to Reclaim Private Industries”

1. Russia’s poorly developed legal system (and its selective enforcement of existing laws) is clearly an impediment to the further emergence of capitalism. If entrepreneurs are uncertain about the safety of their investment, they are less likely to continue to make those investments of time and money. Russia can’t expect its private sector to continue to expand if the legal system does not protect the property that entrepreneurs work to develop. What’s the point of working hard to develop a business, if the central government can arbitrarily decide to take it away from you?
2. Foreign investors are not going to be willing to invest in the Russian economy if the central government can decide to expropriate that business after it has become successful. These investors will simply invest in other countries where they are confident that the legal system will protect their ownership rights.
3. The United States has a long tradition of free markets with a fairly limited role for government in the ownership of the means of production. Altering that role is counter to that long-standing tradition. The Russian tradition is very different, with a much larger role for government in the economy. The Russian government is therefore much less hesitant about taking an ownership stake in enterprises.

■ Answers to Problems and Questions for Discussion

1. An economic system is a set of procedures for answering the three fundamental questions of economics. We identify economic systems according to (1) who owns the means of production, and (2) who makes the economic choices about what, how, and for whom to produce. No two real-world economic systems are exactly alike because no two systems have the same mix of private and public ownership of the means of production, and the same degree of centralized decision making.
2. The elements of pure capitalism are (a) private property and freedom of choice, (b) self-interest, (c) markets and prices, (d) competition, and (e) limited government intervention. In the United States economy, we have a mixture of private and public ownership of the means of production. The pursuit of self-interest is limited or restrained by government regulations and tax policies. Markets and prices coordinate most economic decisions, but government, business, and labor all attempt to influence market forces. Competition is adequate in most industries, but it is not “pure” as required by the model of pure capitalism. Finally, government exerts much more influence on the economy than would be the case in pure capitalism.
3. In a socialist command economy, the central planners answer all of the fundamental questions. In deciding what products to produce, the planners could consider the preferences of the citizens, or they could produce the products desired by the planners or those in power. Their decision would depend on the nature of the political system in the country. In either event, the planners would be constrained by the productive capacity of the economy. In other words, they could not select production objectives beyond the reach of the economy’s producers. Therefore, they would need to acquire data about the economy’s production abilities before they could decide on realistic production targets.

In order to reach these production targets, central planners would have to ensure that each product was produced using as few scarce resources as possible. To do this, they would need to have knowledge of alternative production techniques and select the most efficient method. This information would then be relayed to producers.

Finally, the central planners could distribute the economy's output in accordance with any objectives they desired to achieve. They could ensure an equal distribution of output, or they could distribute output in a way that favored supporters of the existing government.

In the U.S. economy there are several elements of command socialism. Some enterprises are publicly owned. In addition, powerful economic units (government, businesses, and labor) influence market forces. Finally, commands are used to ensure that some decisions are carried out. For example, the government has mandated that seat belts be installed in automobiles; that decision was not left up to free-market forces.

4. Economic planning is designed to coordinate economic decision-making in a command economy. For instance, if steel manufacturers are going to be asked to increase their output of steel, iron ore manufacturers and others who supply inputs to the steel industry must increase their output sufficiently to make this increased steel output possible. In a market economy, the job of coordinating economic decisions is performed by markets and prices.
5. See Exhibit 2.1 in the textbook. Note that there are both product markets and resource markets indicated on the flow diagram. It is in these markets that the prices of products and resources are determined. These prices guide the consumption and production decisions of households and businesses, respectively.
6. See Exhibit 2.2 in the textbook. It is particularly important to note the arrows in the command pyramid and what they indicate about the flow of information and the flow of production targets or directives. Note that information must flow up from the producing and consuming units *before* the central planners can develop their economic plan. Once they have obtained the needed information, they transmit their production targets to the individual enterprises.
7. According to Friedman, competitive capitalism promotes political freedom because it separates economic and political power. Specifically, the existence of private ownership ensures that government officials are not in a position to deny jobs to individuals whose political views differ from their own (as they could in a socialist command economy).
8. In the U.S. economy, government (a) establishes a legal framework, (b) attempts to maintain competition, (c) corrects for externalities, (d) provides public goods, (e) redistributes income, (f) stabilizes the economy—attempts to prevent unemployment or inflation, and (g) imposes health and safety regulations.

If we define pure capitalism as laissez-faire capitalism, the only function that is clearly consistent with the model is the establishment of a legal framework.

9. Capitalism requires private ownership of the means of production. Without a well-defined legal system, private ownership could not be maintained.

10. When a country pursues an industrial policy, government bureaucrats attempt to select industries for special treatment. They decide which industries or sectors are crucial for the future of their economy and provide them with special treatment—low interest loans or subsidies, for example. This degree of government involvement is clearly inconsistent with pure capitalism, where the selection of the economy's winners and losers would be left to market forces.
11. In Japan, South Korea, and Taiwan, government's involvement is primarily intended to promote economic growth, whereas in Germany and Sweden, the fundamental purpose of government intervention is to moderate the income distribution.
12. No; government intervention in the U.S. does not appear to have a single, over-riding purpose, as you can see from the list of functions appearing on Pages 49–52 in the textbook. In fact, there is significant disagreement in the U.S. about the proper role of government in the economy.
13. China is probably concerned about the social unrest that could emerge if the prices of products that are deemed necessities were to rise dramatically. Capitalism and market reforms are still relatively new to China, and the government is clearly proceeding with a degree of caution.