Chapter 4

The Mixed Economy

Learning Objectives

- In this chapter you’ll learn:
  1. The three questions of economics.
  2. The concepts of the profit motive, price mechanism, competition, & capital.
  3. The circular flow model.
  5. Government failure.
  6. The economic role of capital.
  7. The “isms”: capitalism, fascism, communism, and socialism.
  8. The decline and fall of the communist system.

The Three Questions of Economics

- What shall we produce?
- How shall these goods be produced?
- For whom shall these goods be produced?

The Invisible Hand

- Adam Smith coined this term.
- The invisible hand is a kind of economic guidance system that makes everything work out.
- The invisible hand is made possible by people pursuing their own self-interest.
- The bottom line is the “profit motive.”

Market Order

- The Metaphor of the Invisible Hand
- The Price Mechanism
- Competition

Price Mechanism

- The price mechanism is based on the law of supply and demand.
- Prices send signals to both consumers and producers.
Competition

- To have real competition, you need many firms in a particular industry.
  - You need enough so that no one firm is large enough to have any influence over price.
- When sectors of American industry are not very competitive the price system doesn’t work well.
  - The invisible hand becomes less active and more ineffective.
  - The forces of supply and demand are distorted.

Circular Flow Model

![Circular Flow Model Diagram]

The U.S. Economy

![The U.S. Economy Diagram]

Laissez-Faire Economy in the U.S.?

- The United States of America:
  - Has an imperfectly functioning price system.
  - It functions in a less than competitive economy.
  - It is guided by a not too vigorous invisible hand.

Equity & Efficiency

- Does this system allocate limited resources efficiently?
  - Most economists agree that this system leads to a very efficient allocation of resources.

Equity & Efficiency (Continued)

- Does this system lead to a fair distribution of income?
  - No.
- The case for equity
  - Tax away money from the rich and middle class and redistribute it to the needy.
  - This raises the questions:
    - How much do we tax and who do we tax?
    - Will “handouts” lessen incentives to work?
Questions for Thought and Discussion

- Does it make sense that self-interest is enough to create a well-functioning system?
  - What rules need to be in place to allow the Invisible Hand to work its magic?
- How does the U.S. distort market forces?
  - Are these sorts of distortions desirable or undesirable?

Economic Role of Government

- Federal government is made up of
  - Fifty state governments.
  - Tens of thousands of local governments.
- Each
  - Collects taxes.
  - Provides services.
  - Make laws and regulations.
- This somewhat alters the outcome of the three questions:
  - What? How? and For Whom?

Economic Role of Government (Continued)

- The government should
  - Provide the infrastructure for a market to function efficiently.
  - Ensure that competition flourishes.
  - See that information flows freely.
  - Protect property rights.
  - Without property rights, the rest will not matter much.
  - Minimize unpleasant side effects such as pollution.
- The size of government depends largely on how well private enterprise does the job of efficiently allocating resources.

Market Failure

- When our resources are not allocated efficiently, we have market failure.
- Three basic classes of market failure are
  - Externalities.
  - Public goods.
  - Environmental pollution.
  - All provide an opportunity for government to improve on Adam Smith’s “invisible hand.”
- Another cause of market failure is “monopolies.”

Negative Externalities

- External cost
  - This is where the production or consumption of some good or service inflicts cost on a third party without compensation.
  - When you drive your car you cause a certain amount of pollution and congestion.
  - Millions of drivers wear out the highways.
  - Air and water pollution caused by industrial and business activities.
- The government can discourage these activities by taxing you or by imposing stringent regulations.

Positive Externalities

- External Benefits
  - An external benefit occurs when some of the benefits derived from the production or consumption of some good or service are enjoyed by a third party. Government can try to encourage these activities.
  - It is not uncommon for these additional socially beneficial things to be an unintended consequence.
  - If you paint your house (government can give you a grant).
  - Operating a family farm (government can provide you with a subsidy to encourage you to continue to farm).
**Government Action on External Benefits**

- If you are doing something that provides external benefits, the government may provide you with a subsidy to encourage you to continue.
  - For example, the government subsidizes farmers to help keep them from going out of business.

![Graph of Government Action on External Benefits]

**Government Action on External Costs**

- If you are incurring external costs, the government can:
  - Tax you to encourage you to discontinue or change what you are doing.
  - Impose stringent regulations and impose heavy fines for noncompliance.

![Graph of Government Action on External Costs]

**Public Goods and Services**

- Public goods and services are:
  - Nonexcludable: once it exists, everyone can freely benefit from it.
  - Nonrivalrous: one person’s benefiting does not reduce the amount of it available for others.
  - Some examples are national defense, a court system, police and fire protection, the construction and maintenance of streets and highways, bridges, water and sewer mains, environmental protection, public parks, public schools, and public libraries.

**Public Goods and Services (Continued)**

- Tend to be indivisible.
- Usually come in large units that cannot be broken into pieces for purchase or sale in the private market.
- Often there is no way they can be provided by private enterprise because there is no way to exclude anyone from consuming the goods even if she/he did not pay for them.

**Curbing Air and Water Pollution**

- Air and water pollution are perhaps the two greatest external costs of industrial economies.
- Government attempts to control this by:
  - Command-and-control regulations.
  - Incentive-based regulations.

**Government Failure**

- A short list of some the most blatant forms of government failure:
  - The complex and confusing income tax code
  - Government forms and collection of data
  - The agriculture price support system
  - The government war on poverty and welfare programs
  - The public education system
  - The national debt
  - Hurricane Katrina
Questions for Thought and Discussion

- Under what conditions should the government interfere with market forces?
  - What are the dangers of government intervention?

- If a plant is polluting and is not paying for these costs, how might the government approach this problem?
  - Can you use supply and demand graphs to illustrate this solution?

- If people are under purchasing education on the basis of positive externalities, how might the government approach this problem?
  - Can you use supply and demand graphs to illustrate this solution?

Capital

- Capital is the **CRUCIAL** element in every economic system.

- Capital consists of plant & equipment.

- Capital is the key to every country’s standard of living.

- Capital comes from:
  - Cutting consumption (by saving).
  - Americans are now consuming too much and saving too little.
  - Increasing production.

The “Isms”

- Communism:
  - There is no private property.
  - The state owns everything.
  - Government planning committees dictate:
    - What is produced.
    - How it is produced.
    - For whom it is produced.

- Socialism:
  - There is government ownership of some means of production.
    - This usually the most important and largest.
  - There is a substantial degree of government planning.
  - There is a large scale redistribution of income.
  - Promises cradle to grave security.

- Capitalism:
  - There is private ownership of most means of production.
  - The profit motive moves individuals to produce.
  - The price system guides production.
  - The government’s role is kept to a minimum.
  - “The vice of capitalism is that it stands for the unequal sharing of blessings; whereas the virtue of socialism is that it stands for the equal sharing of misery.” —Winston Churchill

- Fascism:
  - Production is in private hands.
  - There is varying degrees of government interference.
  - Those in power are highly nationalistic.
  - The government is intolerant of any political opposition.
  - Suppression of economic freedom, intolerance of any political opposition, and a militaristic orientation are hallmarks of fascism.
Internet Joke

- Socialism
  - You have two cows; the state takes one and gives it to someone else.
- Communism
  - You have two cows; the state takes both of them and gives you milk.
- Fascism
  - You have two cows; the state takes both of them and sells you milk.
- Capitalism
  - You have two cows; you sell one and buy a bull.

The Decline and Fall of the Communist System

- 1920s–1960s
  - Economic growth was very rapid.
  - Government planners concentrated on capital goods (at the expense of consumer goods).
  - The government purposely set prices on consumer goods very low.
  - They wanted even the poorest people to be able to buy the basic necessities.
  - They ended up with constant shortages.

The Decline and Fall of the Communist System: Different Paths for China and the Soviet Union

- The early 1970s
  - Both the Soviet Union and China were facing economies that were faltering.
  - The heavy weight of bureaucratic planning was stifling both economies.
- The late 1970s
  - China began to gradually evolve toward a more market oriented economy.
  - The Soviet Union’s economy continued to stagnate.
  - Most of its capital and talent was devoted to the military and capital goods.

The Decline and Fall of the Communist System: Soviet Union’s Dismantlement

- 1989
  - The Soviet Union was dismembered into 15 separate nations (the largest was Russia).
  - Democratically elected governments replaced Soviet dictatorships.
  - Movement away from government central planning to market economies began.

The Decline and Fall of the Communist System: The Future of Eastern Europe and Former Soviet States

- Will the former Soviet Union countries go capitalist?
  - The collapse of communism is not a vote of confidence in American capitalism.
  - They could evolve into socialist or capitalist democracies.
  - They could swing back toward communist autocracy.
Transformation in China

- 1949–1979
  - The Chinese economy was dominated by Soviet style central planning.

- 1979–1984
  - The government shifted the responsibility of operating huge collective farms from government bureaucrats to the families that lived on the farms.
  - The families could lease the land for 15 years.
  - Output above the government quota could be sold.
  - Output jumped 60%.

Transformation in China (Continued)

- Late 1970s–early 1980s
  - Reform began in the industrial sector.
  - State firms were allowed to sell any surplus output.
  - Family-run enterprises were allowed.

- 1978–2000
  - Exports rose from $5 billion to more than $200 billion.
  - Old credo
    - “From each according to his ability, to each according to his needs.”
  - New Credo
    - “More pay for more work; less pay for less work.”

Questions for Thought and Discussion

- What do the respective experiences of the Soviet Union and the People’s Republic of China tell us about the relationship between markets, wealth, and politics?

- Can politicians forget issues of equity in favor of efficiency when making economic policy?
  - What are the consequences for short changing equity?