

Chapter 4

The Mixed Economy

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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.
 4. Market failure and externalities.
 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.
 9. Transformation in China.

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The Three Questions of Economics

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

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Market Order

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

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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."

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Price Mechanism

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

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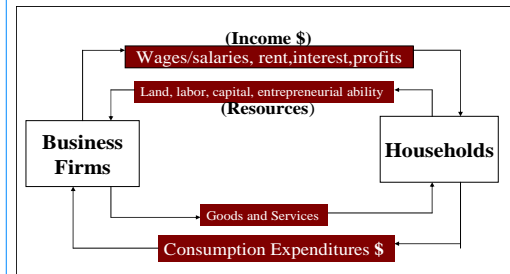
Competition

- ❖ 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.

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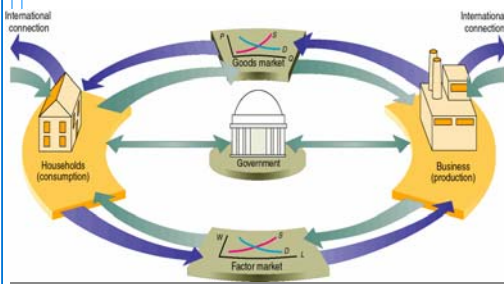
Circular Flow Model



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The U.S. Economy



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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.

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Equity & Efficiency

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

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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?

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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?

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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?

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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.

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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."

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Negative Externalities

- ❖ External cost
 - This is where the production or consumption of some good or service inflict 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.

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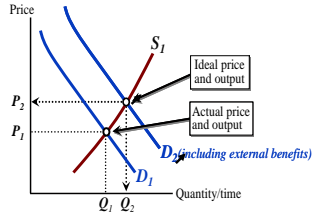
Positive Externalities

- ❖ 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).

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Government Action on External Benefits

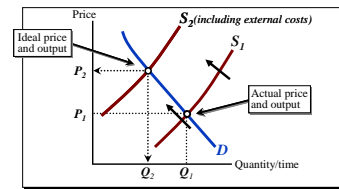


- ❖ If you are doing something that provides external benefits, the government may provide you with a subsidy to encourage you to continue.
 - For example, the government subsidizes farmers to help keep them from going out of business.

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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.
 - The government can impose stringent regulations and impose heavy fines for noncompliance.

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Public Goods and Services

- ❖ Public goods and services are:
 - **Nonexcludable:** once it exists, everyone can freely benefit from it.
 - **Non-rivalrous:** 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.

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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.

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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.

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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

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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?

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Capital

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

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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.

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The "Isms"

- ❖ 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.

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The "Isms"

- ❖ 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

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The "Isms"

- ❖ 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.

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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.

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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.

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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.

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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.

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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.

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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%.

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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.”

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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?

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