

# Lesson 2 - Economic Systems

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## Section 1 - Economic Systems

### Three Questions an Economic System Must Answer for Society

Every society faces some key questions: What goods and services to produce? How to produce those goods and services? and for whom? How a society chooses to answer these questions will in a large part determine the prosperity of the society, its distribution of wealth, and the variety of products and services available. Societies answer these questions either through a decentralized system using markets, a command or central system using government planning, or some combination of the two. We will discuss the different approaches that each of the economic systems takes to answering the questions of:

1. What to produce?
2. How to produce?
3. For whom to produce?

The economic systems can be placed on a continuum with capitalism or the free market system on one end and Socialism or a command system on the other.

### Capitalism

**Capitalism** is a **market system** that relies on private property and the use of markets to answer the societal questions of what to produce, how to produce it, and for whom. A key feature of capitalism is that individuals act in their own **self-interest** as they seek to improve their well-being. Households willingly supply their resources so that they can purchase goods and services which they value more. Since consumers are able to purchase the goods and services they want, they **vote with their dollars** and signal to the market what is of value to them. If a business is not producing what is in demand, they will find that they are better off to use their resources producing something else that consumers want. Thus in a market economy, the consumers are the ones that ultimately determine what will be produced.

Under capitalism, individuals are rewarded for their contribution based on how society values that contribution. This is one reason why the church strongly encourages each member to get a good education. While pure capitalism rewards individuals for their contribution, individuals are also exposed to the risks of the market if they are not producing what consumers want. This provides an incentive to work towards meeting the needs and wants of consumers, but it also can lead to a wide variation in the **distribution of income**.

"Get all the education you can. I repeat, I do not care what you want to be as long as it is honorable. A car mechanic, a brick layer, a plumber, an electrician, a doctor, a lawyer, a merchant, but not a thief. But whatever you are, take the opportunity to train for it and make the best of that opportunity. Society will reward you according to your worth as it perceives that worth. Now is the great day of preparation for each of you. If it means sacrifice, then sacrifice. That sacrifice will become the best investment you have ever made, for you will reap returns from it all the days of your lives."

Gordon B. Hinckley, *Teachings of Gordon B. Hinckley*, pp. 172-173

As Adam Smith outlined, each person seeking their own self interest in turn promotes the best interest of society by producing those goods and services most desired, all as if by an invisible hand. According to him, each individual, seeking only his own gain, "is led by an invisible hand to promote an end which was no part of his intention"--that end being the public interest.

The view of capitalism is that a **Laissez-faire** market can function without government intervention. The term **Laissez-faire** is French, and essentially means "leave it alone." Under capitalism, businesses have an incentive to always produce where they incur the lowest costs. If they are not producing in the least-cost manner, another business would be able to produce the product at a lower cost, undercut the competition, and take away sales. As new technologies are developed, firms have an incentive to adopt the technologies if doing so will allow them to produce at a lower cost. With the use of the markets, goods and services will be distributed to those who are willing and able to pay the market price; thus, the market price serves as the rationing mechanism, determining who gets the product. A common misconception is that Laissez-faire markets do not take care of the poor and needy. However, when an individual acts in their self-interest they pursue activities that bring the greatest joy or satisfaction, which may actually include service or philanthropic acts. While these do not increase the financial status of an individual, they may bring the individual great satisfaction.

"How selfish soever man may be supposed, there are evidently some principles in his nature which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it."

Adam Smith, *The Theory of Moral Sentiments*

## Socialism

"The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."

Winston Churchill, "Demobilisation," speech in the House of Commons, Oct. 22, 1945

An alternative economic system is **socialism (command or centrally planned economy)**, in which the government seeks to use the nation's resources for all of its citizens, instead of letting the citizens use the resources in the manner they best see fit. Thus, under socialism the government owns or controls the property and answers the three questions of what to produce, how to produce, and for whom. There are different degrees of socialism, one being communism, that was envisioned by Karl Marx consisting of collective ownership of resources and decisions made by central planning committees. Under socialism, there is one pie that is divided among all of the citizens. Unfortunately, central planners with the best intentions may not be able to represent each individual's preferences in their decisions. Because of scarcity, central planners must decide not only what to produce, but also how to ration the produced goods and services among the various consumers (recall there will always be unlimited wants and limited resources). The difficulty of determining who gets a product is often lost on the casual observer of centrally planned economies – but this is one of the most difficult decisions that has to be made – who will go without.

Most countries in the world, including the United States, use a **mix** of private and government enterprises to allocate the nation's resources in providing goods and services. These **mixed economies** rely on the private market to produce and allocate certain goods and services while the government controls the provision of other goods, such as welfare and Medicaid in the United States.

## The United Order

As members of the Church, we recognize that there will some day be an economic system in place that will be uniquely different from the current economic systems of today. That system is sometimes referred to as "The United Order."

In the United Order, individual property rights will be an important component in the economy. Marion G. Romney taught: “As to property, in harmony with Church belief as set forth in the Doctrine and Covenants, no government can exist in peace, except such laws are framed and held inviolate as will secure to each individual the free exercise of conscience, [and] the right and control of property.” (D&C 134:2.) The united order is operated upon the principle of private ownership and individual management. Thus, in both ownership and management of property, the United Order preserved to men their God-given agency. In this way, He holds each steward accountable for his own work and productivity.

The United Order, according to Elder Harold B. Lee, is “more capitalistic ... than either Socialism or Communism, in that private ownership and individual responsibility will be maintained” (In Conference Report, Oct. 1941, p. 113.). J. Reuben Clark, Jr. said: “The Church never was, and under existing commandments never will be, a communal society, under the directions thus far given by the Lord. The United Order was not communal nor communistic. It was completely and intensely individualistic, with a consecration of unneeded surpluses for the support of the Church and the poor.” (J. Reuben Clark, Jr., “The United Order and Law of Consecration As Set Out in the Revelations of the Lord,” from a pamphlet of articles reprinted from the Church Section of the Deseret News, 1942, pp. 26–27.)

## Ponder and Prove - Section 1 - Economic Systems

**Section 1 Questions** +

*Instructions: Click on the button that represents the correct answer. After you select an answer, click on the 'Grade My Answer' button.*

Question 1 | Question 2 | Question 3

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**Which of the following is a NOT associated with capitalism?**

- Central planning
- Invisible hand
- Private property
- Self-interest

Grade My Answer    Reset

"Results"

Original source code for problem above from Craig Bauling. Modified by David Barrus

## Section 2 - Market Systems - Circular Flow

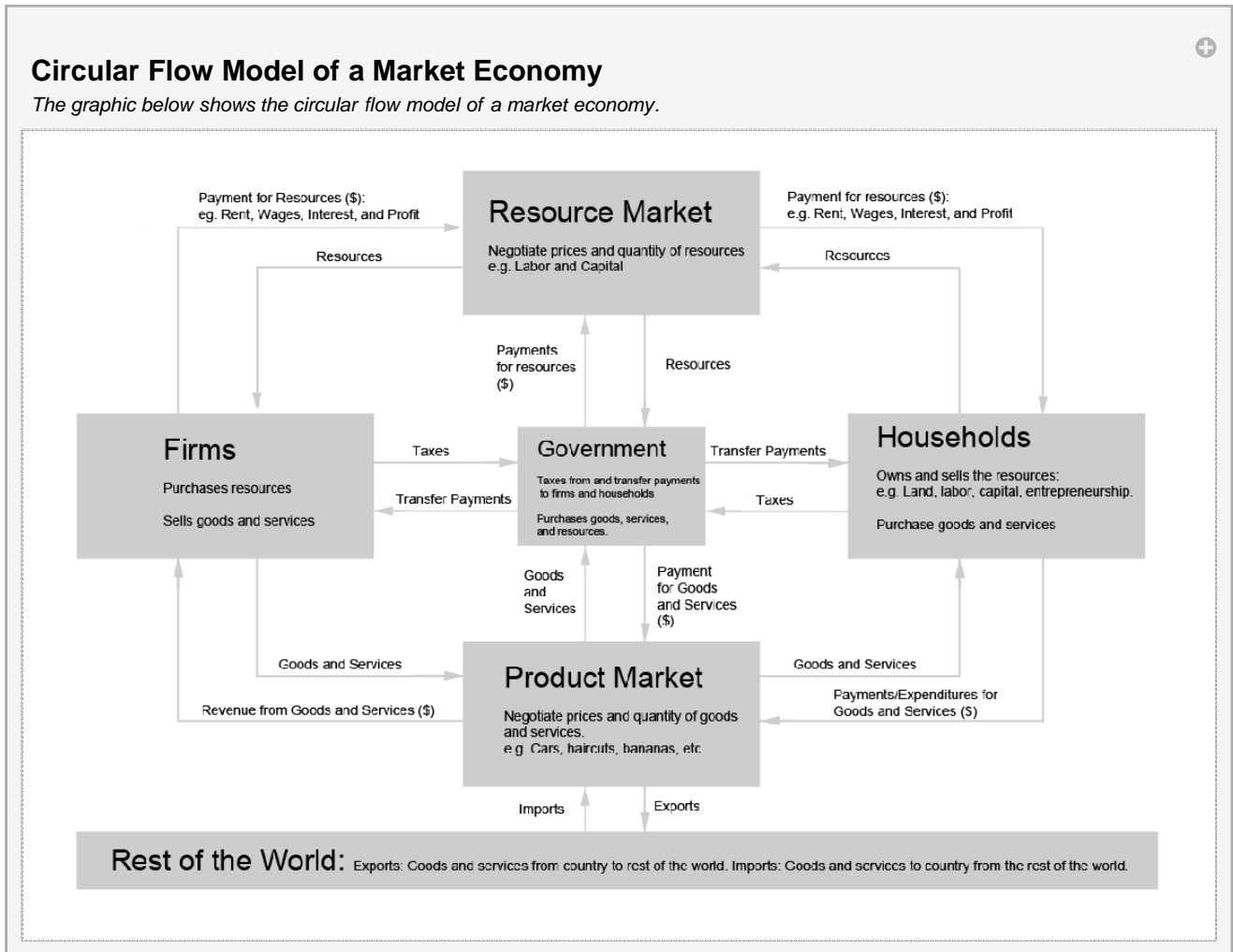
### Circular Flow and the Market System

In a market system, the households own the resources and willingly supply those to businesses in the resource market in return for a payment for the use of those resources. Remember that households are paid wages for their labor, interest for their capital, rent for their land, and profit for their entrepreneurial ability. Businesses are willing to purchase the resources, provided they can convert them into goods and services that will return at least a normal profit. The quantities and prices of resources are determined by the supply and demand of the resources in the resource market.

Households use the payments they receive from the use of their resources to purchase goods and services that businesses produce. The provision and purchase of goods and services takes place in the product market. In the inside ring is the flow of resources and goods and services, while the outer ring is where the monetary transactions take place.

When government becomes a player in the economy, they interact with households and businesses through taxation and transfers. The government also purchases resources from the resource markets as well as goods and services from the product market.

As the economy opens trade with other countries, foreign nations demand and supply goods and services in the product market, and they also demand and supply resources in the resource market. The figure below illustrates the circular flow model of the economy.



## Ponder and Prove - Section 2 - Market System - Circular Flow

### Section 2 Questions +

*Instructions: Click on the button that represents the correct answer. After you select an answer, click on the 'Grade My Answer' button.*

Question 1 | **Question 2** | Question 3 | Question 4 | Question 5

**Which number represents the government in the circular flow chart?**

3  
  2  
  1  
  4  
  5

**"Results"**

Original source code for problem above from Craig Bauling. Modified by David Barrus

## Summary

### Key Terms

**Capitalism:** a market system that relies on private property and the use of markets to answer the societal questions of what to produce, how to produce it, and for whom.

**Centrally Planned Economy:** an economic system in which the government seeks to use the nation's resources for all of its citizens, instead of letting the citizens use the resources in the manner they best see fit.

**Circular Flow Model:** a model exemplifying the circular flow of economic resources through households and firms within a market economy.

**Command Economy:** see Centrally Planned Economy

**Distribution of Income:** the allocation of income within a society.

**Laissez – faire:** a French term that essentially means “Leave it alone.” A Laissez-faire market is able to function without government intervention.

**Market Economy:** see Capitalism

**Mixed Economies:** an economic system that use a mix of private and government enterprises to allocate the

nation's resources in providing goods and services.

**Private Property:** an individual or non-public ownership of an economic resource.

**Self-interest:** the motivation to improve one's well-being.

**Socialism:** an economic system in which the government seeks to use the nation's resources for all of its citizens, instead of letting the citizens use the resources in the manner they best see fit.

**Three Questions Economies Must Answer:** What to produce? How to produce? For whom to produce?

**United Order:** an economic system which operates upon the principle of private ownership and individual management.

## Objectives

### Section 1

1. Explain how the market system answers the three basic questions of what to produce, how to produce, and for whom.
2. Explain the differences between different economic systems.
3. Explain how Adam Smith's "invisible hand" works in a market economy.

### Section 2

1. Draw and explain the circular flow diagram