

## CHAPTER 2

# ECONOMIC SYSTEMS, RESOURCE ALLOCATION, AND SOCIAL WELL-BEING: LESSONS FROM CHINA'S TRANSITION

### LESSONS FROM CHINA'S TRANSITION

The transition of China's economy from centralized planning to a market-oriented economy provides an outstanding backdrop against which the efficiency of the market economy can be compared to that of a command economy. While this analysis is of necessity limited, students should come away with a clear notion of the importance of private property rights and individual choice within the market economy and how these are limited in the command economy.

We introduce students to the market process of resource allocation through supply and demand analysis. The presentation is designed to show that, with exceptions, the market is capable of bringing about an allocation of resources that maximizes social well-being without input from government. Contrasted with this, we discuss resource allocation and the resulting well-being when resources are allocated by government decree as would happen in a command economy.

### TEACHING OUTLINE

- I. Brief History of the Chinese economy
- II. Economic Systems
  - A. Pure market economy
    - 1. Private property rights
    - 2. Decentralized decision-making coordinated through markets
  - B. Pure command economy
    - 1. State ownership and/or control of economic resources
    - 2. Centralized planning
  - C. Mixed systems
    - 1. Transitional economy
- III. Market Structures
  - A. Pure Competition
    - 1. Large number of buyers and sellers

2. Each seller offers standardized product
  3. Product prices free to move up or down
  4. Buyers and sellers must be mobile
  5. Freedom entry and exit
- B. Pure monopolistic market
1. One seller with price control
  2. Blocked entry
- C. Imperfectly competitive markets
- IV. Demand and Supply
- A. Demand
1. Demand versus quantity demanded
  2. Demand is for a period of time
  3. Law of demand
    - a. Ceteris paribus
      - i. Income
      - ii. Price of related goods
      - iii. Tastes
      - iv. Buyer's expectations
      - v. Number of consumers
  4. Change in demand versus a change in quantity demanded
  5. Changes in the factors held constant along a demand curve
- B. Supply
1. Supply versus quantity supplied
  2. Supply is for a period of time

- 3. Law of supply
  - a. Ceteris paribus
    - i. Cost of production
    - ii. Price of related goods
    - iii. Seller's expectations
    - iv. Number of sellers
  - 4. Changes in supply versus changes in quantity supplied
  - 5. Changes in the factors held constant along a supply curve
- C. Market equilibrium
  - 1. Equilibrium price and quantity
    - a. Prices above equilibrium
    - b. Prices below equilibrium
- V. Resource Allocation in a Command Economy
  - A. Centralized planning
    - 1. The Communist Revolution in China
    - 2. Establishment of a Command Economy
  - B. Problems with centralized planning
    - 1. Initial Phase
    - 2. Great Leap Forward
      - a. State Planning Commission
    - 3. Cultural Revolution
  - C. Shortcomings of Central Planning
    - 1. Informational requirements
    - 2. Incentives for efficient production
    - 3. Heavy industry versus consumer goods

VI. The New Chinese Economy

A. China's transition to a market oriented economy

1. Agricultural reform
2. Industrial reform
3. Lessons for other economies

B. China's Transition to Markets: What are the Facts?

C. Problems of transition in China

1. Unemployment and inflation
2. Corruption
3. Population pressures
4. Pollution problems
5. The desire for democracy

VII. Summary

## CORE ECONOMIC PRINCIPLES

- ◆ Market Structures - The concept of market structures, discussed further in Chapter 8, is presented in this chapter. Market structures are important in microeconomic analysis; the concepts of competition and monopoly come up throughout the text, economics, and the "real world."
- ◆ Demand and Supply - The most important model introduced and applied in this chapter is the supply and demand model. Economic systems are used to introduce students to this model, used throughout the text and all of economics. The chapter leads into Chapter 3, which applies the supply and demand model to the analysis of price ceilings and floors.

## RESOURCES

### Data Links

For up-to-date information on China, consult the CIA Factbook at <https://www.cia.gov/library/publications/the-world-factbook/index.html>.

### Curriculum Ideas

For a classroom experiment on demand, see Expornomics, Vol. 1, #2. For a classroom experiment on supply and demand, see Vol. 3, #1.

<http://www.marietta.edu/~delemeeg/expornom.html>

Introductory Economics Videos from Films for the Humanities and Sciences, *Understanding Free Market Economics* videotape series.

## **DATA SOURCES**

The following data sources may be used to update and refine the statistics found in this chapter:

- A great deal of social, demographic, historical, cultural, and economic data is available for most countries of the world through the Central Intelligence Agency's public web site found at <http://odci.gov/cia/publications/factbook/index.html>. Especially interesting for students is to have them compare and contrast resource endowments of various countries and then relate resource endowments to economic and political systems and finally to measures of economic well-being.

## **DISCUSSION QUESTIONS**

1. The defining characteristics of the pure market economy are private ownership and control of resources and decentralized decision making with respect to resource use. How well does the U.S. satisfy these characteristics? Would you recommend any changes that might make the U.S. more market-oriented?
2. Compare and contrast the pure market and pure command economies.
3. Identify elements within the U.S. economy that cause us to classify it as a mixed market rather than pure market economy.
4. Why have the transitional economies had such a difficult time in converting to the market orientation?
5. Would you expect the demand curves for most, if not all, goods and services to slope downward to the right? Explain why or why not.
6. Would you expect the supply curves for most, if not all, goods and services to slope downward to the right? Explain why or why not.
7. Show graphically and explain the impact of the market for orange juice of a severe freeze in the orange growing region of Florida.
8. By considering the market forces that come into action when prices are either above or below the equilibrium level, explain how the price of a product is determined in a competitive market.
9. Distinguish carefully between a "change in demand" and a "change in the quantity demanded." List several real-world examples of each.

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10. Discuss the following statement: “The price of gas has fallen recently from \$3.00 to \$2.75 per gallon. We can be sure that this fall in the price of gas will cause an increase in the demand for gas which will, in turn, cause the price of gas to go back up.”
11. When either demand or supply changes, we can easily predict the impact on the equilibrium price and quantity sold of a product. When both demand and supply change at the same time, however, we can only accurately predict the impact on one of the two key variables, price and quantity, unless we have additional information. Explain why this is the case and also indicate what additional information is necessary for us to be able to predict the impact on both price and quantity in this situation.
12. The law of demand states that consumers tend to buy more at low prices than at high prices, other things being equal. What are these other things that must be equal? In other words, don't consumers always tend to buy more at lower prices than at higher prices?
13. The law of supply states that sellers would prefer to sell at high prices rather than low, other things being equal. What other things must be equal?
14. Explain why it is said that the equilibrium reached by a competitive market of necessity indicates that unique allocation of an economy's scarce resources that maximizes social well-being.
15. Explain how markets, if left on their own, tend to eliminate any shortages or surpluses that might arise for a particular good or service.
16. Discuss: “In order to argue in favor of the command economy, you must believe that the government knows what will give you satisfaction better than you do.”
17. List and briefly explain the conditions necessary to conclude that pure competition exists within a given market.
18. Suppose that at the beginning of the school year in your town, there are 6 - 8 shops that would deliver pizza to your home. By the following spring, a merger has created a pure monopoly in the pizza market. Describe the changes, as a customer, you might expect.
19. One of the conditions of pure competition is that there can be no barriers to entry or exit from the market. What is the importance of this condition?
20. What role would advertising play in a purely competitive market?