

# CHAPTER 2

## The Modern Mixed Economy

### CHAPTER OUTLINE

- I. The Market Mechanism
  - a. Not Chaos, but Economic Order
    - i. Market Equilibrium
  - b. How Markets solve the Three Economic Problems
    - i. What?
    - ii. How?
    - iii. For whom?
  - c. The Dual Monarchy
    - i. Tastes and Technology
  - d. A Picture of Prices and Markets
  - e. The Invisible Hand
- II. Trade, Money, and Capital
  - a. Trade, Specialization, and Division of Labor
  - b. Money: The Lubricant of Exchange
  - c. Capital
    - i. Growth from the Sacrifice of Current Consumption
  - d. Capital and Private Property
- III. The Invisible Hand of Government
  - a. Efficiency
    - i. Imperfect Competition
    - ii. Externalities
    - iii. Public Goods
  - b. Equity
  - c. Macroeconomic Growth and Stability
  - d. The Rise of the Welfare State
    - i. Conservative Backlash
- IV. Summary

## CHAPTER OVERVIEW AND TEACHING TIPS

This is an ambitious chapter that sets the tone for the rest of the textbook. The chapter introduces a series of fundamental ideas and concepts, both from a Micro and macro perspective, that define the essence of the economic problem. They are important because they form the foundation for the analysis of a market economy. The tools and methods that you present to students in this chapter will be carried throughout the text and developed in greater detail as you make your way through the course. Here is a great opportunity for you to give students a broad introduction to “the economic way of thinking.” Instructors are advised to be extremely patient when covering this chapter; this is definitely not the time to cut corners. A solid understanding of the material presented in this chapter will pay-off big dividends later on. Instructors should also exploit every opportunity that the chapter provides in terms of real world applications; the updated discussion about Globalization on page 30 should be an excellent catalyst for discussion.

The chapter begins with an introduction of the market mechanism. The concept of the market, market equilibrium, prices and how markets solve economic problems (what, how, for whom) are the important features of this section. Everything comes together through the lens of Smith’s Invisible Hand metaphor. Later chapters will fill in important details.

Section B introduces the concepts of Trade, Money and Capital. As you might anticipate, Trade is related to Smith’s presentation of the division of labor. While on this subject, it will be wise to inform the students about the dangers of extreme division of labor. Recall that Smith actually was in favor of government financing education because he was afraid that the division of labor would lead individuals to perform monotonous activities that will wear down their intelligence. Instructors must also emphasize the difference between money (the lubricant of exchange) and capital (the sacrifice of current consumption).

Section C introduces a role for government in an economy from the perspective of market failures. Efficiency and equity are examined as well as macroeconomic goals like growth and stability. Again, caution and patience will be your best allies as you navigate Micro and Macro waters simultaneously. These topics will come back later in more detail; this is an excellent opportunity to lay down a solid foundation.

## LEARNING OBJECTIVES

- 1 Describe what is meant by the term *market* and describe the process of achieving *equilibrium* in a market economy.
- 2 Use your definition of market equilibrium to address three basic economic problems that confront all societies.
- 3 Explain how the price system works as an *invisible hand*, allocating goods and services in a market economy.
- 4 Understand the importance of *specialization*, the *division of labor*, *money*, *factors of production* and *capital* and *property rights* in the functioning of a modern economy.
- 5 Use a *circular-flow diagram* to illustrate the relationships between agents and markets in a modern economy.
- 6 Make a case for government intervention in a mixed market economy in order to promote *efficiency*, *equity*, and *macroeconomic growth* and *stability*.

## SUGGESTED ANSWERS TO QUESTIONS IN THE TEXT

- 1 In all of these cases, a combination of consumer choice and government directives or incentive plans (a mixed economy) determine the ultimate allocation of resources.
- 2 Auctions are not always practical, ration coupons hold prices artificially low, and first come first served leads to high opportunity costs of standing in line. A market “rations” goods to those consumers who can afford them.
- 3 There are lots of potential government failures. Some would argue that AFDC has been a failure; more children live in poverty in the United States today than in many other industrialized countries. Would it be better to live with this market failure? We shall see.
- 4 *Pollution limitations*: improving efficiency (public bad) *Income supplements*: equity (redistribution program) *Phone regulation*: efficiency (prices higher, output lower with monopoly)
- 5 Money goes in the opposite direction, i.e., from businesses to the suppliers of inputs and from households to the suppliers of outputs. Money functions to make transactions easier and more efficient.

## Chapter 02 - The Modern Mixed Economy

6. The question gives the opportunity to develop a story about the evolution of the division and specialization of labor. From a subsistence/low living standards in the 1800s to a more dynamic and globalized world in 2009. Although the question emphasizes the potential advantages of the present due to productivity and trade, students (or the instructor) might bring the issue of vulnerability; life for Jones was more difficult but he probably was never unemployed!
7. There were arguments that slaves were property. Some argued that because slaves had to be housed and fed from birth and trained from adolescence, they represented “human” capital—human elements of roundabout production. I am sure that you can find a lot to write about such a dehumanizing thought.
8. Social security helps to promote equity in the distribution of income. National defense represents provision of a public good. Unemployment insurance provides for stability through the business cycle. Administration of justice often deals with imperfect competition and market failure. Pollution control battles a negative externality, while funding for basic science encourages a positive externality.
9. Unlike a private good where you must reveal your preferences to receive the good, public goods are provided by the government and are paid for by taxes collected by the government. It is important that the one who is paying for the good have a say in what is provided by the government.
  - a. The best way to voice your concern about defense spending is at the ballot box.
  - b. You can voice your displeasure at the ballot box or move to a jurisdiction where the tax is not being collected.
  - c. Take alternative means of travel to Miami or not travel to Miami.

### DISCUSSION QUESTIONS

1. What is meant by a “mixed economy?” Is it socialist? Communist?
2. It has been said that prices serve a rationing function and a guidepost function. What could this mean?
3. Use a market diagram to show how prices coordinate the behavior of buyers and sellers. What if buyers want to purchase more units of a particular good than sellers want to provide? How will the price system provide incentives in this situation?
4. The how, what, and for whom questions are solved differently in different economic systems. Consider each of the following and explain how the three big questions of economic organization are solved (a) within your family, (b) within your college or university, and (c) in the agriculture industry.
5. What considerations do you think have caused leaders in Eastern Europe to lessen their hostility toward the value of the pricing system? What about the people? If market economies work better than other types of economic rationing systems, why is it so difficult for countries like Russia and Poland to chart a new economic course?
6. Why do you suppose that history has never seen a period of complete laissez-faire? Do you think nineteenth century America came reasonably close? What would your Utopia look like?
7. “Losses are as important as profits in a pricing system.” Why? What function do losses serve?
8. Identify a few economic areas in which the government is currently active. Are these activities directed primarily toward correcting problems of equity, efficiency, or stability? Are they working? Discuss positive and negative effects of government intervention in the economy.
9. The social security system was devised to help Americans during their retirement years. It has grown beyond that objective. What are the current objectives of the system, and are there side effects that add to or subtract from its ability to meet those objectives?
10. Why is the decision whether to consume today or tomorrow so important to society? Who makes this decision in the United States? In Cuba?
11. “A socialist nation and a capitalist nation do not differ in the fundamental economic problems that they face; they differ in the ways they go about solving those problems.” Do you agree? Why or why not? Do they also differ in what they consider to be desirable solutions?
12. Do you think society could organize 200 million people on the principles of the kibbutz or cooperative? Why or why not?
13. “The need of U.S. manufacturers to spend large sums on advertising to stimulate artificial wants indicates that economic scarcity will soon lose its relevance.” Is this true, and if not true now, is it likely to become so?
14. Who loses, or stands to lose, when trade opens? Do they always lose? Can short-term losses turn into long-term gains?
15. What types of stabilization policies can you think of? Are they consistent with the objectives of equity and efficiency?
16. Equity and efficiency can run counter to each other. Why?
17. Do markets always do a good job of distributing resources to people who need them most? To people who want them most? Explain.

## Chapter 02 - The Modern Mixed Economy

## ESSAY QUESTIONS

1. Sketch a diagram to show how markets and prices link households and businesses to solve the three economic problems. Explain the direction of money flows and the accompanying flows of goods and factor inputs.
2. Prices in a market system have sometimes been described as fulfilling a “rationing” function.
  - a. In what sense do prices “ration?” Why is rationing needed in an economic system as productive as ours?
  - b. In the market for energy, what are the factors determining to whom the world’s supply of oil is distributed?
  - c. Suppose a shortage of wheat exists. How does the price system react to bring about an increase in wheat production?
3. Indicate the manner in which the market system provides a solution to the for whom question in a free enterprise economy. In the present American economy, what other factors are important?
4. “The U.S. economic system is mixed in at least two senses.” Elaborate on this statement.
5. List and discuss (a) the various factors inherent in our economy that make perfect competition an unrealistic description of our economic system; (b) the factors responsible for the existence of monopoly elements in our society.
6. “The bulk of all economic activity is directed toward the future.” What would be the significance of this for our society? Is it true?
7. Government in a mixed society can (a) purchase goods and services, (b) produce goods and services, (c) transfer income from one group of people to another, (d) tax its citizens, and (e) borrow and/or lend money. Pick examples of each and discuss how equity, efficiency, and stabilization objectives are met in your examples.
8. In *The Zero Sum Society*, Lester Thurow speculates on how economic interaction can take place without one person’s gain resulting in another’s loss. What do you think of that notion? How might it relate to globalization?
9. Contrast the use of barter and money in a modern mixed economy that uses many capital goods and involves much specialization and interdependence. Concentrate on the efficiency of transactions—the cost involved in conducting business.
10. “Specialization gives rise to differences in skill; differences in skill give rise to specialization.” Can both statements be true? Would specialization be worthwhile if everyone were identical?
11. In what sense do specialization and division of labor depend on the size of the market? Does this help explain the phenomenon of continuing economic growth?
12. Specialization is not entirely problem-free. Discuss some of the troublesome effects of specialization on workers, the workplace, and society as a whole.
13. Country A can produce all goods more efficiently than Country B. The opportunity costs of production, however, are different. Can trade ever benefit Country A?
14. Discuss the fundamental difference between Milton Friedman’s ideas about a market economy and John Maynard Keynes’ ideas about a market economy. What are their major points of disagreement?
15. Discuss the problems associated with providing the service of a lighthouse to ships.