

What is an Economy?

Have you ever seen the movie "The Gods Must Be Crazy"? If you have, you will have seen a family of bushmen who live in the Kalahari Desert. These people live in small nomadic groups, generally family, that hunt and gather. My question to you is do they have an economy?

NO They do not have an economy because _____

YES They do have an economy because _____

The bushmen do have an economy, because they engage in the three types of activities that make up an economic system.

An **ECONOMY** is that sphere of social activity involved in the production, distribution and consumption of material goods and services.

The THREE functions of an ECONOMIC SYSTEM

Generally, students will associate economic activities with what they are familiar with, such as going to the store or working at a job. Today, however I would like you to examine a broader range of activities and ask yourself, Are these economic in nature?

Consider these activities.

- Deciding whether to have hamburger or chicken for dinner.
- Deciding whether you are going to do a painting or a drawing for your art project.
- Deciding which bedrooms you and your roommate will have.

All economic activities answer one or more of the following questions that must be addressed by an economic system.

1. **What to Produce?**
Deciding whether to have hamburger or chicken for dinner, is an example of an economic activity that performs this function.
2. **How to Produce it?**
Deciding whether you are going to do a painting or a drawing for your art project, is an example of an economic activity that addresses this question.
3. **How to Distribute the output?**
Deciding which bedrooms you and your roommate will have, is an example of distribution of the output. Think of this one in terms of who gets to consume what is made.

Types of Economic Systems

There have been five main types of economic systems that have existed historically.

1. **Traditional economies**- Traditional economies are characterized by subsistence. Individuals produce for themselves most of the things that they consume and if they need something they cannot make they will barter for it. The three economic functions are answered by current needs and traditions.
2. **Feudal economies**- Feudal economies are organized around land ownership. Workers are attached to the land where they are born. If land is transferred, they stay with the land. Most of the important economic decisions are made by the landowners.
3. **Slave economies**- In slave economies, labor is viewed as property. Those who own the slaves make the important economic decisions.
4. **Market or Capitalist economies**- Market economies have three main characteristics; wage labor, private ownership of the means of production and exchange is done through markets. Markets are coordinated by price and decisions are decentralized, that is each individual makes his own economic decisions.
5. **Socialist economies or Command economies**- Socialist economies are characterized by public ownership of the means of production and central planning. These economies have a planning bureau that makes the important economic decisions.

Most economies today are **mixed economies**, that is these economies have some combination of market, socialist or traditional economies described above. The U.S. has a mixed economy. There is a large private sector where goods are provided through markets. There is also a public sector in which the government makes the decisions about what to produce, how to produce it and who will have the output. Some goods that are provided through the public sector are the military, public education, and roads.

How do Markets Perform the Three Functions of an Economic System?

Imagine that it is about eleven o'clock on a Saturday night and you are very hungry. All you can think about is one of those big, fat, juicy cheeseburgers from your favorite fast food restaurant. So you head over to the restaurant, drive up to the take out window and order the cheeseburger. A few minutes later the server hands to you a **fish fillet** sandwich. Needless to say you are rather disappointed and think to yourself that given the poor service, that you will go to a competing restaurant next time.

In market economies the question,

1. **What to Produce?** is answered by what consumers demand. In market economies producers are motivated to produce what buyers want, so that is what they produce.

Now imagine that you have just finished ordering that cheeseburger you want. The restaurant immediately calls in a chef trained at the Cordon Bleu, to make one up for you. Of course the restaurant is going to have to ask you to pay some exorbitantly high price. You of course don't have it, so you don't pay and leave without the cheeseburger.

In market economies the question,

2. **How to Produce it?** is answered by producers seeking the most cost efficient method to produce the output. Producers want to stay in business, so they look to provide the consumer with what he wants at the lowest cost.

Now imagine that when you get to the window, instead of ordering that delicious cheeseburger that ran out of the house to get, you ask for a fish fillet sandwich. Then before you get your order, you realize that in your haste to satisfy your hunger, you left your wallet at home. Now of course you know that there is no way you would have ordered that fish fillet sandwich but what is going to determine whether you get to take home the cheeseburger? That is going to depend on whether you find enough change under the car seat or not.

In market economies the question,

3. **How to Distribute the output?** is answered by the willingness and ability of consumers to demand the output. In order to have a demand for something a consumer has to both want it and be able to pay for it. If a consumer doesn't demand a good it will not get produced. This goes back to that first economic function, What to produce?. Markets will only produce what consumers demand, so if someone is too poor to demand something it doesn't get produced.

This brings us to one of the most important characteristics of markets; Markets are very **EFFICIENT** but they are not necessarily **EQUITABLE** in the distribution of the output.

Market economies are very efficient. Producers are motivated to produce what consumers want so there aren't a lot of shortages or surpluses of goods. Producers are also motivated to find the most cost efficient methods to produce those goods. Resources don't get wasted.

However the distribution of the output is dependent on the distribution of income which in many cases is dependent on chance. The result is that the distribution of the output could end up to be highly inequitable. This was one of Marx's main criticisms of capitalism and why communism was favored in some countries.

On the other hand Markets are preferred by many despite this shortcoming because they consider markets with its decentralized decision making as freer and more supportive of democratic institutions.