

The Basic Decisions of any Economy

The first thing we need to see in understanding the economic process is that there are certain basic economic decisions which all peoples must make if they intend to go on living.

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- 1. WHAT SHALL BE PRODUCED?
- The first decision to be made is: what shall be produced?
- The things people can desire are infinite, but the energies and resources of any society are limited. A few things must be done, a few desires satisfied, and many things must be left undone.
- Now how do we make this decision as to what to produce? In a highly complex society, it is certainly a complicated and difficult decision.
- Yet, just as in simpler societies, it does get made. Let us look at three possible ways of making this first decision, and all other decisions.

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Tradition.

- One is through tradition.
- In this system the answer to the question "what shall be produced?" is "what our great-grandfathers produced."
- The chief products of the Trobriand Islanders, when the anthropologist Malinowski did his famous study of them during World War I, were yams, fish, and a number of objects that were exchanged as ritual gifts from one island group to another. As long as the islands were not influenced by the white man, there was no real question as to whether to grow more yams, or catch much less fish, or make more or fewer ritual gifts.
- All this continued to be done as it had always been done. On the medieval manor, certain lands were traditionally allocated for different uses, and a certain number of artisans - shoemakers, tailors, carpenters, goldsmiths - were attached to the manor house. Sons, to a very large extent, carried on their father's occupation. In such a society change was very slow and the idea of progress hardly existed. What was to be produced was determined here, also, by traditional usage.

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- The Market

The next way is through the market.

- The term, of course, originally referred to a place where people came together to buy and sell. In its social science usage, it refers to the relationships among buyers and sellers.
- We all know what we mean when we speak of the fluctuations on the stock market, or say that there are too many school graduates for the labour market, or say that there is a bumper crop of apples this year and that the market will be poor for apple growers.
- In the last case, we mean that the relationship between buyers and sellers, or between supply and demand, will bring a low price to growers.

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- When we say that what is produced may be determined by market mechanisms, we mean that it may be determined by forces of supply and demand.
- Let's consider the case of wheat. Obviously, the higher the price, the more wheat farmers are likely to produce. Clearly, the lower the price is, the more wheat consumers will tend to buy. We will notice that there is a certain price at which the wheat offered for sale will equal the wheat bought. At this price, the market is in equilibrium.
- If less wheat were offered, the demand would drive the price up and encourage more wheat production. If more wheat were produced, there would be a surplus, the price would drop, and eventually farmers would produce something else instead. Perhaps they would grow barley or sugar beet instead.
- Thus the forces **of supply and demand** determine how much of the resources will go into wheat production. This is a small part of the whole decision of what shall be produced.
- **The most important thing to notice is that nobody has planned this. A decision has been reached simply by letting people buy and sell.**
- As the great economist Adam Smith put it, **the decision is made as though guided by an "invisible hand."**

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- Now suppose that instead of thinking of wheat, we imagine all the possible products that could be made - milk,, automobiles, houses, oil clothes, TV sets, mobile phones, laptops, rubber tires, children's toys,etc. How much of each will be made, at what price? Now we have to think of a vast market - actually worth billions of euros- in which all possible products are competing for consumers.
- How much of each will be produced will depend upon how many people demand it. One way of putting this is to say that in a market economy, production is determined by the "**ballot box of the market place**". Just as political candidates are elected or rejected according to the number of votes they get, so potential products are "elected" by euros or dollars) of the consuming public.
- Check out how the Apples ipad mini or Samsung Galaxy Pad is selling.
<http://www.valuwalk.com/2012/11/apple-inc-aapl-ipad-sales-slow-down-as-android-tablet-sales-continue-to-gain/>.

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- We will note that market decisions require free competition, what is also called "free enterprise". We do not have decisions by the **invisible hand of supply and demand** if the **visible hand of government intervenes**.
- The spending of a great part of a country's national income for military purposes is not, for example, a free market decision. Nor do we have a free market decision if private businesses become so big that they can fix prices and quantity of production, as seems to be the case in many industries.

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- A free market could exist only in an economy where all businesses were small, so that none could dominate the market, and anyone with a little capital could move in or out of any line of production fairly easy.
- This is obviously not the case in Western society today in the markets for automobiles, meat, rubber, aluminum, steel, and many other commodities. Western economies today are far from a free market society, just as are all large industrial economies. Nevertheless, the concept of the free market is a useful one, just as in physics we find useful the concept of a vacuum, which never exists in pure form in reality, either.

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- **Planning**

- We come now to the third way of deciding what is to be produced, which is by planning.
- One case which we have already suggested is the one where businesses cooperate to restrict free competition. Any of us can observe, for example, that the prices of all regular brands of petrol are about the same and generally rise and fall together. Usually this happens because of an unwritten agreement by petrol producers not to undercut one another. This control by a few firms is also called oligopoly. (Control by one firm is called monopoly).
- **The type of planning which contrasts most sharply with the free market is direct government planning.** We have many examples of direct government planning. Municipal power, garbage collection, the post office system, the allocation of the military budget are all examples of economic decisions by government. Public ownership of railroads is one widespread example of government planning in many European economies.

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- The greatest contrast to the free market method of making decisions is found in the so-called Communist countries. In the former Soviet Union much production was planned periodically and indeed constantly, through a central agency.
- We must note that, just as there are both private and government planning in Western society, so there are market mechanisms in Communist China today.
- Indeed, these have been accentuated in recent years. Under economic reforms factories now must compete with one another for consumers, rather than being assured the sale of their planned quota of product. All this will suggest that there are no purely planned or market economies, that in reality all present economic systems are mixed economies. However, we usually think of a society like that of the United States as stressing the market, those of the Communist China as stressing planning, and use the term "mixed economy" for systems like those of the Western Europe.

How shall Resources be Allocated?

- Actually, this is a subheading of the first decision, for to decide what is to be done is to decide, to a large extent, that resources are to be used in one way rather than another. However, this second large decision involves specific kinds of choices. Let us see how they affect three major factors of production which economists have traditionally distinguished. These are **land, labour and capital equipment**.

How shall Resources be Allocated?

- **Land**
- Land includes all those natural resources that have not been produced by humans. Land includes the soil itself plus all the natural resources, such as minerals, Forests, waters, etc.
- Any economic system must decide to what uses to put its land. As an example of a market decision, let us take a fictional case . Thirty years ago a considerable part of this county was orange groves. Today a large number of these groves have been bulldozed away and replaced by subdivisions.
- How did this change take place? With the development of the city, land became more valuable as building sites than for agricultural use - thus the bulldozer and residential construction.
- No person or organisation planned this change. On the other hand, land use is restricted by public zoning policy in this county as elsewhere. Even if a petrol station or an industrial plant would represent the most profitable use of a certain piece of land in a residential area, the land cannot be so used.
- If it wishes to build an expressway over it, the state can take the land through its right of eminent domain. Both zoning and the principle of eminent domain represent planned allocation of land.

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- **Labour**

- Labour may similarly be allocated by either market or planning mechanisms. A sailor in the merchant marine faced by the prospect that ships will be automated, may retrain himself to be an airplane mechanic. Large numbers of farmers and unskilled workers have left rural areas in the hope of finding better jobs in cities. Scientists have moved from the underdeveloped countries to the Western nations, and from Eastern Europe to the west, in such numbers that the phenomenon has been called the "brain drain".
- Such changes all represent allocation by the pull of the market. On the contrary, slave labour camps, the military draft, and compulsory national service all constitute allocation of labour through planning. Government employment exchanges and job retraining programs are a less drastic form of government planning of the labour supply.
- The same principles hold for managerial talent, which is a specialised form of labour. In Western economy, capable executives and managers tend to be drawn into those activities which will yield the highest income.
- In the planned Communist economy, they are more likely to be assigned by government planning agencies. In the industrial capitalist countries, however, government is also able to influence the allocation of managerial talent through its ability to draw it away from private enterprise into government jobs.

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- Capital equipment
- Capital equipment includes all those products of human labour with which other products are made. They are also called "**instruments of production.**" Factories and the machinery they contain; highways and the equipment of airlines, railways, trucking and steamship lines; farm buildings, machinery are some important forms of capital equipment in an industrial economy.
- Corporation taxes are an example of planned allocation. By taking away corporate profits, taxes make it possible for the government to invest money in highways, or parks, or military bases instead of allowing industry to use them to build new plants. Thus corporation taxes shift the creation of capital equipment from the private to the public sector of the economy.

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- **The choice of consumption or investment**
- Allocation of capital equipment presupposes that the third major decision of any economy has already been made. This is the choice between consumption and investment or between present and future goods.
- Although it also usually involves the spending of money savings, investment in this sense refers primarily to the creation of new capital equipment.
- There is no society so simple that it puts all its work time into directly making or getting goods to be consumed. Even the simplest economy spends some time making the simple tools with which he digs roots or hunts game.
- The time taken for making diggers, bows and spears must be subtracted from the time available for hunting or digging. The tools are made because, in the long run, more food can be obtained by taking a little time in the short run to make the tools. Thus one of the characteristics of production in all societies is a certain amount of "roundaboutness". The more complex the society, the more roundabout production is likely to be, that is, the greater the importance of capital equipment as compared with simple labour.

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- In capitalistic societies **capital equipment** is largely privately owned. In communist economies this is not the case.
- But both types of economy must decide, all the time, how much of their energy and resources to apply directly to producing goods for consumption, and how much to apply to making things which will not be consumed themselves, but used to make other goods.
- Capital investment is usually of two kinds. Since existing equipment wears out, some resources and energy must always be devoted to replacing it. In addition, every growing economy is constantly adding to its stock of equipment.
- If too little is set aside for investment, the economy eventually suffers from lack of capital equipment. If too much is set aside, there may be an immediate shortage of consumer goods; then in the longer run, much productive equipment may lie idle because of a lack of demand for its products.

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- Where market mechanisms prevail, the choice of how much to withdraw from consumption for purposes of investment is made primarily through a large number of decisions by private individuals or corporations.
- In planned economies it is made primarily by the planning agencies. We may note that different types of economies have different kinds of problems of consumption and investment.
- The poor, underdeveloped countries - have the problem of trying to save for investment in a situation where most of the people may not even have enough to eat.
- An economy might have to choose among investment for future production, the demands of military expenditure, and the demands of citizens for consumer goods, in short, among factories, guns, and bread.

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- Many countries are potentially so productive that no one should need to be poor in order to support investment.
- However, there are many rich nations with people living in poverty. Military expenditure consumes about one-sixth of the United States' national product. The American system of distribution allows many people to be poor even when there is more than enough to go around.
- http://www.eurofound.europa.eu/ewco/surveyreports/EU0703019D/EU0703019D_1.htm
- <http://www.sciencedaily.com/releases/2008/10/081031102640.htm>

How shall Resources be Allocated?

- HOW SHOULD INCOME BE DISTRIBUTED?

How should income be distributed? Who should get what? Let us examine three possible standards which may be used for deciding how income is to be distributed:

- equality,
- need and
- contribution.

How shall Resources be Allocated?

- **Equality**

- Equality has always had a strong appeal, not only to the self-interest of those who are on the short end of inequality, but also to our sense of justice. Many voluntary communities, including those of the early Christians and the Israeli collectives (kibbutzim), have tried it.
- Of course, while the "have-nots" may think equality would be a pretty good thing, the "haves" are likely to have doubts
- And there are other problems. If everything were divided up equally, how long would things stay that way? Would not people with more intelligence, or more energy, or fewer scruples soon have a larger share again?
- If there were no possibility of achieving a larger income, what incentives would there be to prepare oneself and work hard? Would not the economy slow to a standstill for lack of motivation?

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- There are also strong arguments in favor of equality. Unequal reward seems to assume that people are unequally worthy.
- Who is to judge a human being's worth? If we do not have equality of income, then the children of those with a higher income start life with an advantage.
- How can there be equality of opportunity if people do not begin the race of life at the same starting point?
- As for lack of motivation, the advocates of equality might answer that humankind does not live by bread alone. People work for reasons other than the mere hope of gain.
- There is another strong argument, if not for complete equality, at least against too great inequality. *If too much goes to a few people of wealth and the mass of people have little income, who is going to consume the products of the economy? Such is the case in Many EU countries where austerity policy has stagnated spending of the middle and working class.*

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- **Need**

- A second answer to the problem rejects equality in favor of **need**. A man and woman with a family needs more than a single individual.
- A family with special health problems needs more than a family in perfect health.
- A scholar may need books, a musician scores or instruments in which a manual labourer is not interested.
- Again, questions arise. Perhaps we can agree that every person needs certain things just to stay alive and keep working, but few of us would settle for that.
- The wealthier the economy, the more things seem to be necessary. Is a car a necessity for us? | A separate bedroom for each member of the family?
- Are high definition TV's, iPhone, computers , access to music or art class, or an annual holiday luxuries or necessities? How do we distinguish needs from mere wants?
- **Yet can we be unconcerned if any of our fellow human beings lack the basic necessities of life?**

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- **Contribution**

The third possible standard is **contribution**.

Let a person be rewarded according to what he/she has added to the welfare of society. Certainly there is merit in this criterion.

- Is it not reasonable that society should reward those who have served it well? Immediately ?
- The market system has an answer. Let each person offer his talents to the market, and the demand for his services will measure his contribution.
- But is the sale price which one's services can demand necessarily a measure of his social usefulness? Is a football star worth more to society than a farmer earns considerably less?
- Moreover, the market measures only in a very short run.
- What about those who contribute not only today but to future generations? Is a popular series or TV actor or an X factor winner worth more to society than an Einstein or a Ghandi? More than Ellen Johnson Sirleaf, Leymah Gbowee, Tawakkol Karman, Liu Xiaobo, Bruce A. Beutler, Jules A. Hoffmann, Ralph M. Steinman

http://www.nobelprize.org/nobel_prizes/medicine/laureates/2011/

http://www.nobelprize.org/nobel_prizes/physics/

http://www.nobelprize.org/nobel_prizes/literature/laureates/2012/

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- There is another question here. How much of one's ability to earn an income can be attributed to an individual?
- We have already seen that we start the race of life with unequal chances.
- Each of us is also heir to all the advantages of a rich and technologically developed society. Isaac Newton once said that he could contribute to science as he did because he *"stood on the shoulders of giants."* Who would be what he/she is had been born in another place, or time, or with parents with a different income?
- Is it just to reward a person for having the right parents, the right gender or, for being born at the right place and time?

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- Market or planning?
- Which is a better way to make the basic decisions of **an economy - through the market or through planning?** In its pure form, decision by the market mechanisms make one's marketability almost the only standard in rewarding one with income.
- This has been the traditional Western way of free enterprise. To this philosophy attempts at equality are pernicious, for they stifle enterprise.
- It is one's responsibility to care for his/her own needs, and if we cannot or will not, it may be a concern for private charity, but not for public policy.
- Today, of course, this rugged individualism has been modified, and both equality and need form a part of our public policy and distribution. Minimum wages laws set a floor under income. Social security provides that minimum needs of the aged and the unemployed shall be met. The proposal that everyone should have a guaranteed minimum income, regardless of work, is based on ideas of need and equality rather than contribution.

- The most highly developed planned economy, the former Soviet Union, has theoretically based its distribution on the policies of Lenin.
- According to these, there would be two stages of development in distribution.
- The first was described by the phrase, "To each according to his ability, from each according to his work."
- "Work" might sound much like "contribution" in the capitalist economies, but to Lenin it meant socially useful work in the service of their social revolution.
- It excluded as socially useless, and parasitic, many activities which earn large incomes in capitalistic countries. Income was to a large extent set by planning agencies. In the second phase, the motto would be, said Lenin, "*From each according to his ability, to each according to his needs.*"
- He looked forward to a society so affluent that reward according to contribution would no longer be necessary, since there would be enough for everyone's needs. Of course history has shown this did not happen with the collapse of the former Soviet block .

For example, prior to the early 1990s the state owned all the natural resources and almost all the capital in the Soviet Union. At least in theory, goods were produced to meet the needs of the people. Access to housing and medical care was considered to be a right. Leaders of the Soviet Union and some Eastern European nations decided to abandon government ownership and control of the means of production because the system was unresponsive to the needs of the marketplace and offered no incentive for increased efficiency (Boyes and Melvin, 2011). Since the 1990s, Russia and other states in the former Soviet Union have attempted to privatize ownership of production. Economic reforms in the 1990s privatized most industries, with the exceptions of the energy and defense-related sectors.

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- Sweden illustrates a different combination of standards of distribution. It is a much more affluent country, being close to the United States in per capita income. 90 percent of its enterprise is privately owned. But a considerable part of this 90 percent is made up of consumers' and producers' cooperatives. They are in considerable measure responsible for the philosophy of public responsibility for distribution which is summarised in the phrase "welfare state."
- Sweden has been so successful in establishing minimum standards of need that we can say, for all practical purposes, that no one lives in poverty. This is possible because of high taxation which also insures that there are very few rich people. From these taxes come public funds which ensure almost cradle-to-grave security, benefits to mothers, nursery school services, sickness and unemployment insurance, and retirement benefits amounting to two-thirds of the income of one's fifteen most productive years. Thus Sweden has combined a market economy with the elimination of great inequality and provision for most basic needs.

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- Which is a better way to make the basic decisions of an economy - through the **market** or through **planning**?
- Advocates of the market insist that this is the only democratic way to make them. They argue, also, that the market stimulates more energetic efforts and thus produces a more dynamic type of economy. Advocates of planning say that the market is not democratic, inasmuch as one "votes" as a consumer not on the basis of equality, but on the basis of income. Those with high income dominate this "ballot box."
- As we have seen, every modern economy to some degree employs both methods. Even China 

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- China—previously the world's other major communist economy—has privatized many state industries. In *privatization* resources are converted from state ownership to private ownership; the government takes an active role in developing, recognizing, and protecting private property rights (Boyes and Melvin, 2011).
- In the second decade of the twenty-first century, China has a **hybrid political economy made up of both capitalism and an autocratic form of Communist Party governance**.
- Double-digit economic growth has brought about an increase in annual urban income, life expectancy has increased by more than six years, and the rate of illiteracy has dropped significantly.
- With these improvements for middle-class Chinese, it is likely that the combination of communism and a modified form of capitalism will remain for the foreseeable future (Jacobs, 2011).
- Both Russia and China have undergone significant changes in recent years, moving from globally isolated, centrally controlled economies to more market-based and globally integrated economies

