

shipped from the Prairies to Central Canada, and automobiles are shipped in the reverse direction. Such specialization and trade allow for higher incomes and standards of living. If the Prairies and Central Canada were politically defined as separate countries, the same analysis would still hold, but we would call it international trade. Indeed, Europe is smaller than Canada in area, but instead of one nation, Europe has 15. What we call *interprovincial trade* in Canada is called *international trade* in Europe. There is no difference, however, in the economic results—both yield greater economic efficiency and higher average incomes.

Political problems that do not normally arise within a particular nation often do between nations. For example, if Nova Scotia crab fishers develop a cheaper method of harvesting crabs than fishers in British Columbia, British Columbia fishers will lose out. They cannot do much about the situation, except try to lower their own costs of production. If crab fishers in Alaska, however, develop a cheaper method, both Nova Scotia and British Columbia fishers can (and likely will) try to raise political barriers to prevent Alaskan fishers from freely selling their product in Canada. Canadian crab fishers will use such arguments as “unfair” competition and loss of Canadian jobs. In so doing, they are only partly right: crab-fishing jobs may decline in Canada, but jobs will not necessarily decline overall. If the argument of Canadian crab fishers had any validity, every time a region in Canada developed a better way to produce a product manufactured somewhere else in the country, employment in Canada would decline. That has never happened and never will.

When countries specialize where they have a comparative advantage and then trade with the rest of the world, the average standard of living in the world rises. In effect, international trade allows the world to move from inside the global production possibilities curve toward the curve itself, thereby improving worldwide economic efficiency.

The Division of Labour

Division of labour Individuals specializing in a subset of tasks related to a specific product.

In any firm that includes specialized human and nonhuman resources, there is a division of labour among those resources. **Division of labour** occurs when individuals specialize in a subset of tasks related to a specific product. The best-known example of all time comes from one of the earliest and perhaps most famous economists, Adam Smith, who, in his book *The Wealth of Nations* (1776), illustrated the benefits of a division of labour in the making of pins: “One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper.”

Making pins this way allowed 10 workers without very much skill to make almost 48 000 pins “of a middling size” in a day. One worker, toiling alone, could have made perhaps 20 pins a day; therefore, 10 workers could have produced 200. Division of labour allowed for an increase in the daily output of the pin factory from 200 to 48 000! (Smith did not attribute all of the gain to the division of labour according to talent but credited also the use of machinery and the fact that less time was spent shifting from task to task.)

What we are discussing here involves a division of the resource called labour into different kinds of labour. The different kinds of labour are organized in such a way as to increase the amount of output possible from the fixed resources available. We can, therefore, talk about an organized division of labour within a firm leading to increased output.

2.5 Economic Systems

Economic system The social arrangements or institutional means through which resources are used to satisfy human wants.

In the remainder of this chapter, we will study some of the established social arrangements that various nations use in choosing their production possibilities that, realistically, can include millions of goods and services being produced to satisfy the wants of millions of consumers.

At any point in time, every nation has its own **economic system**, which can be defined as the social arrangements or institutional means through which resources are used to

satisfy human wants. No matter what institutional means—marketplace or government—a nation chooses to use, the following three basic economic questions must always be answered because of the economic problem of scarcity.

1. *What and how much will be produced?* Literally billions of different things could be produced with society's scarce resources, but not all at the same time. Some mechanism must exist that causes some things to be produced and others to remain as either inventors' pipe dreams or individuals' unfulfilled desires.
2. *How will it be produced?* There are many ways to produce a desired item. It is possible to use more labour and less capital or *vice versa*. It is possible to use more unskilled labour and fewer units of skilled labour. Somehow, in some way, a decision must be made as to the particular mix of inputs, the way they should be organized, and how they are brought together at a particular place.
3. *For whom will it be produced?* Once a commodity is produced, who should get it? In a modern economy, individuals and businesses purchase commodities with money income. The question then is what mechanism is there to distribute income, which then determines how commodities are distributed throughout the economy.

Not long ago, in response to the problem of scarcity, textbooks presented two extreme economic systems as possible polar alternatives for the industrialized nations to consider—the *pure command economy* versus the *pure capitalist economy*—in order to answer the three basic economic questions. Despite the fact that many countries have recently moved away from a command economy, it is appropriate to review both types of economic systems. This is because many informed citizens within Canada and other capitalist economies feel that elements of the command economy should prevail in the provision of important services, such as health care, education, and national security.

Pure Command Economy

Public (government) ownership of all property resources characterizes a pure command economy. A **pure command economy** is an economic system characterized by public ownership of all property resources. The three basic economic questions—What, How, For Whom—are answered in a very centralized manner by government or the “state.” Detailed five-year plans are formulated by the central authorities in order to respond to the three basic economic questions.

Until recently, such nations as Russia and China used the pure command economy to make their resource-allocation decisions. In the past, this type of system has typically been associated with nations practising communism or socialism.

Pure command economy An economic system characterized by public ownership of all property resources.

Pure Capitalist Economy

In contrast to the pure command economy, a **pure capitalist economy** is an economic system characterized by private ownership of all property resources. Households and firms interacting through a system of markets answer the three basic economic questions—What, How, For Whom—in a decentralized manner. The pure capitalist economy goes by other names, such as *capitalism*, *market economy*, or *price system*.

Pure capitalist economy An economic system characterized by private ownership of all property resources.

Mixed Economic Systems

The pure command and the pure capitalist systems are extreme economic systems. Real-world economies, which typically fall somewhere between these two extreme systems, are called mixed economies. In **mixed economies**, decisions about how resources are used are made partly by the private sector and partly by the public sector. As an example, Canada is referred to as a mixed capitalist system. This is because, while the majority of products are produced in the private sector, there are other goods and services provided by the government.

Mixed economy An economic system in which decisions about how resources are used are made partly by the private sector and partly by the public sector.

2.6 Capitalism in More Depth

Since there has been a global trend away from pure command economies toward capitalist economies, we will describe pure capitalism in more depth below.

Features of Capitalism

In elaborating on the pure capitalist economy, we will periodically refer to the Circular Flow Model presented in Figure 2–5.

Key features of pure capitalism include:

1. *Private ownership of resources:* Individual households and individual firms own the productive resources in pure capitalism. As described in Figure 2–5, households have two essential roles in capitalism—they supply resources to firms, and they demand goods and services with the income received from supplying resources. Firms, in turn, demand or hire resources in order to supply goods and services to households.
2. *Self-interest:* The primary motive underlying decisions made by households and firms in pure capitalism is the pursuit of self-interest. More specifically, firms attempt to maximize their own profit, when deciding what resources to demand or hire and what products to supply. Similarly, households are assumed to attempt to maximize individual wealth and other personal goals when deciding on where to supply their resources. When demanding goods and services, households attempt to maximize self-satisfaction or utility.
3. *Consumer sovereignty:* The pure capitalist system is to serve the household in its consumer role. Operationally, this means that capitalism is to produce the mix of goods and services that consumers desire, at the lowest possible prices.
4. *Markets and prices:* The Circular Flow Diagram in Figure 2–5 indicates the two broad types of markets that exist in pure capitalism—product markets and factor (resource) markets. When consumer demand changes or resource availability changes, this sets off changes in relative prices in affected product and factor markets. These price changes ultimately reallocate resources in line with the change in consumer demand or resource availability. While we will examine how prices are determined in individual markets in the chapters that follow, we will provide a simple example below.

Suppose that consumer demand for red wine increases and consumer demand for cigarettes decreases. Referring to the product markets in Figure 2–5, the price of red wine will increase, while the price of cigarettes will decrease. The higher price for red wine serves as a signal to firms that red wine is now relatively more profitable to produce than cigarettes.

Driven by the profit motive, the red wine firms will increase their demand to hire resources, while the cigarette firms will decrease their demand for resources, to reduce their losses. Prices will now change in the factor markets in Figure 2–5. Prices (i.e., wages) of resources (i.e., employees) that engage in the production of red wine will increase relative to the prices offered to resources in the cigarette industry. Resources,

FIGURE 2–5
Circular Flow Model

This model describes how households and firms interact through both product and factor markets in a pure capitalist economy. In the product markets, the households demand goods and services, while the firms supply the goods and services. In the factor markets, these roles are reversed. That is, households supply the resources, and the firms demand the resources.



guided by self-interest, will move out of cigarette production and into the production of red wine. Eventually, red wine production will increase. Note how this system of markets and prices operates to reallocate resources in line with changes in consumer demand, thus promoting consumer sovereignty.

5. *Competition:* In order to ensure that the self-interests of firms and resources work to the best interests of consumers, it is necessary that many independent sellers and buyers compete in each market. This will be more fully explained in the subsequent chapters of this text.
6. *Limited government:* To the extent that competition exists in each market, the “invisible hand” of self-interest will serve to promote consumer sovereignty. Hence, allocating resources to meet changes in consumer demand does not require the “heavy hand” of government. The French have termed this feature of capitalism “*laissez-faire*,” which means that the government should leave it (the economy) alone or “let it be.”

Laissez-faire French term for “leave it alone”; the government should leave it (the economy) alone or “let it be.”

One way to remember some of the important attributes of the market economy is by thinking of capitalism’s **Three Ps**: Private property, Profits, and Prices.

As Policy Example 2–2 outlines, political factors play a role in issues surrounding the use of alternate economic systems to allocate and distribute our limited economic resources, goods, and services.

Three Ps Private property, Profits, and Prices inherent in capitalism.

POLICY EXAMPLE 2–2 Canadian Politics: Right, Left, and Centre

Chapter 1 noted that Canadian government policies are, in part, based on economic theories applied to government efforts that attempt to achieve key socioeconomic goals. To more fully understand how policies are determined, it is important to recognize that political factors often play an important role. That is, policies are frequently guided by the principles of the political party of the government in power. In Canada, the three major political parties at both the federal and provincial levels are the Conservatives, the New Democrats, and the Liberals. The Conservative Party, often referred to as the right-wing party, seeks to move the economy more toward the pure capitalist model, with private ownership and competition, decentralized individual decision-making through free markets, and a *laissez-faire* approach to the economy. The New Democrats, who sit on the left side of the political landscape, place a high priority on serving the interests of labour and working families, promoting social justice, reducing poverty and inequality, protecting the rights of minorities, and ensuring public funding and provision of social programs and services. Often, the principles of the New Democrats tend to move various industries and services in the direction of a command system, with more government involvement. The Liberal Party, known as the centralists, supports a variety of policies from both the right and the left ends of the political spectrum, seemingly guided by public opinion as identified through political polls. The most recent federal Liberal Party emphasized the importance of balancing the government budget with providing affordable social programs. Liberals typically favour mixed economic systems. Voters who wish to avoid extreme shifts in policies often vote for the Liberals.

For critical analysis: State whether each of the following policies is more consistent with the principles of the Conservatives or New Democrats. Policy A: Waiting time for surgeries is reduced through the expansion of government-funded surgical units located in government-run hospitals. Policy B: Waiting time for surgeries is reduced through the provision of new surgical services through privately owned health-care clinics.

Sources: “Founding Principles. Getting things done for all of us.” The Conservative Party of Canada. <http://www.conservative.ca>. (Accessed June 1, 2007.); “Issues. NDP.” The NDP Party of Canada. <http://www.ndp.ca/> (Accessed June 1, 2007.); “Vision. Liberal—Stronger Together.” Liberal Party of Canada. http://www.liberal.ca/default_e.aspx. (Accessed June 1, 2007.)

TABLE 2-2

Production Costs for 100 Units of Product X

Technique A or B can be used to produce the same output. Obviously, B will be used because its total cost is less than A's. Using production technique B will generate a \$2 savings for every 100 units produced.

Inputs	Input Unit Price	A		B	
		Production Technique A (input units)	Cost	Production Technique B (input units)	Cost
Labour	\$10	5	\$50	4	\$40
Capital	8	4	32	5	40
Total cost of 100 units			82		80

Capitalism and the Three Economic Questions

Now that we have reviewed the essential features of pure capitalism, we can proceed to examine how this economic system operates to answer the three basic economic questions—What, How, and For Whom.

WHAT AND HOW MUCH WILL BE PRODUCED? Since firms can enhance profits by producing what consumers are willing to buy, we can see that consumer demand plays an important role in deciding what goods and services are produced. In more formal terms, the profit motive and competition lead firms to promote allocative efficiency—that is, firms will produce the mix of goods and services most wanted by society. However, we must keep in mind that if the highest price that consumers are willing to pay for a good is less than the lowest resource cost at which the good can be produced, no profit will result, and none of this good will be produced. In other words, resource availability also plays a role in determining what goods and services are produced.

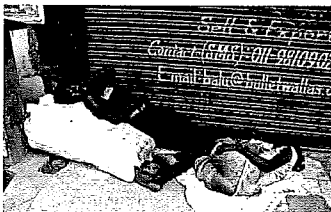
HOW WILL IT BE PRODUCED? The question of how output will be produced in a pure capitalist system relates to the efficient use of scarce inputs. Consider the possibility of using only two types of resources: capital and labour. A firm may have the options given in Table 2-2. It can use various combinations of labour and capital to produce the same amount of output.

Two hypothetical combinations are given in Table 2-2. How then is it decided which combination will be used? Under pure capitalism, the least cost combination (technique B, in our example) will be chosen by firms because it will maximize profits. In other words, in pure capitalism, competition and the profit motive encourage firms to achieve productive efficiency.

FOR WHOM WILL IT BE PRODUCED? This last question involves how households share in the consumption of the goods and services produced. This, in turn, is based on the distribution of money incomes and wealth among households. Households with higher levels of income and wealth will get to purchase and consume a greater portion of the goods produced in the economy.

What determines the distribution of wealth and money income among different households? This distribution is based on the quantities, qualities, and types of the various human and nonhuman resources that different households own and supply to the marketplace. Households that own large quantities of resources that are highly in demand in the marketplace will earn high levels of income.

As Example 2-5 illustrates, the way in which a nation answers the economic question “For whom will it be produced?” will affect what and how much will be produced.



How can improved sanitation in India improve economic well being?

EXAMPLE 2-5 India Has More Cellphones Than Toilets

Since the early 1990s, India, the second most crowded country in the world, has moved significantly closer to becoming a capitalist economy. According to a report undertaken by United Nations University (UNU) in Tokyo, released in April 2010, India is now wealthy enough to have 45 percent of its population own a cellphone (545 million cellphones), yet only 31 percent of

continued

its population (366 million people) have access to clean toilet facilities. In other words, about 1.2 billion people in India do not have access to basic sanitation. The UNU report points out that there would be a return of between \$3 and \$4 for every additional dollar spent on improved sanitation due to reduced health and poverty related costs, as well as higher productivity.

Source: "Mobile telephones more common than toilets in India, UN report finds." UN News Centre. United Nations University, Tokyo. April 14, 2010. <http://www.un.org/apps/news/story.asp?NewsID=34369&Cr=mdg&Cr1=>

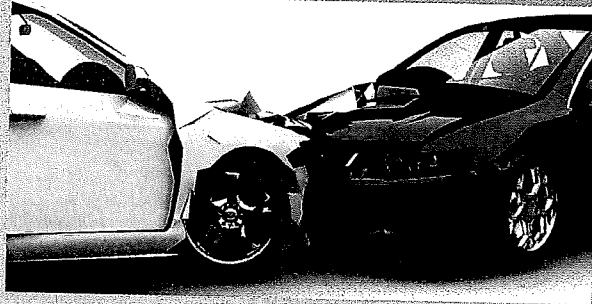
For critical analysis: Using this Example, explain how the way India answers the economic question "For whom will it be produced?" has affected what and how much will be produced. Since total wealth in India is increasing rapidly, can you suggest a government policy that could improve basic sanitation conditions? How will this policy pay for itself in the long run?

It should be noted that many current debates regarding economic systems apply to individual industries within a national economy. The central question posed in this chapter's Issues and Applications is, "What economic system should be used to best provide auto insurance in Canada?" As this Issues and Applications section points out, different economic systems are currently being used to provide auto insurance in Canada, depending on the province in which one resides.

ISSUES AND APPLICATIONS

Private or Public Auto Insurance: What Is Best for Canada?

Concepts Applied: Capitalist, Command, and Mixed Systems; Productive Efficiency; Allocative Efficiency; and Equity



How does establishing fault in accidents affect the cost of car insurance?

In response to public outrage over skyrocketing car insurance premiums, the Consumers' Association of Canada completed a comprehensive report on auto insurance rates in Canada in September 2003. In presenting the report, the association noted that government-owned, or public, auto insurance systems offer the lowest premiums for Canadian drivers.

Provincial Automobile Insurance Rates

Figure 2-6, taken from the report, compares the average annual auto insurance premiums among provinces, assuming the same insurance coverage, vehicle, driving record, and claims history. The average premiums are based on over 7000 rate quotes across Canada. All quotes assume an insurance

coverage of \$2 million liability, \$500 collision deductible, and \$300 comprehensive deductible. As you can see from this figure, the annual car insurance premiums are significantly lower in the provinces of British Columbia, Saskatchewan, Manitoba, and Quebec, where the mandatory insurance is provided by a government monopoly.

The Consumers' Association of Canada's report also noted the differences in the annual rate of increase in premiums between the private and public insurance systems in 2003. While premiums were escalating by up to 70 percent per year in the six provinces where privately owned insurance companies operate, Manitoba's publicly run auto insurance system was increasing annual premiums by only 7.2 percent.