



# Planning Activity

## Theme 1

This document provides an example of a plan for one topic within Theme 1. This resource goes into much more detail than is required in the specification but it provides some background to the topic and suggested approaches for planning content.

The approach to planning taken in this document was to:

- Identify the specification content and possible links to other topics in the specification
- Identify resources to support delivery – these might include:
  - Support resources including sample assessment materials and Getting Started guide
  - Published resources including textbooks
  - Websites and news stories
- Identify the **knowledge**, **application**, **analysis** and **evaluation** relevant to that content
- Develop activities and resources – these might include:
  - Multiple choice questions from past papers
  - Worksheets
  - Past and new case studies
  - Practice questions for explain, calculate, assess and evaluate (where appropriate)



## The market and the state

<p>1.1.6 Free market economies, mixed economy and command economy</p>	<p>a) The distinction between free market, mixed and command economies: reference to Adam Smith, Friedrich Hayek and Karl Marx</p> <p>b) The advantages and disadvantages of a free market economy and a command economy</p> <p>c) The role of the state in a mixed economy</p>
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Possible specification links	1.1.2	Value judgements made on the role of the state in the economy (the extent of state involvement which is desirable)
	1.1.5	Adam Smith and specialisation
	1.2.6c 1.2.7	Operation of market forces very much in line with the Smith/Hayek thinking
	1.3	Market failure justifying a role for the state
	1.4.	Role of the state sometimes benign, sometimes not
	2.2.3b	Keynes
	2.6.	Desirability or otherwise of government macroeconomic policy
	3.6	Government intervention in markets – regulation
	4.5.1	Government expenditure – opinions on the desirability or otherwise of increasing/decreasing public expenditure as a proportion of GDP
	4.5.2	Taxation – opinions on increasing or decreasing the proportion of income spent by individuals or spent by the state
4.5.4	Different opinions on government macro-economic policy	



## Resources

### **Adam Smith**

<https://www.youtube.com/watch?v=ulyVXa-u4wE>

### **Karl Marx**

<http://www.open.edu/openlearn/whats-on/tv/ou-on-the-bbc-masters-money-marx>

[https://www.youtube.com/watch?v=sd\\_FUexLSSQ&list=PLFcQ2qIKjEPqvZR5r5msuKJGFeBs-JPsr](https://www.youtube.com/watch?v=sd_FUexLSSQ&list=PLFcQ2qIKjEPqvZR5r5msuKJGFeBs-JPsr)

### **Friedrich Hayek**

<http://www.open.edu/openlearn/whats-on/tv/ou-on-the-bbc-masters-money-hayek>

<https://www.youtube.com/watch?v=A8bfTjp6Xw0&list=PLFcQ2qIKjEPqvZR5r5msuKJGFeBs-JPsr&index=2>

### **John Maynard Keynes**

<http://www.open.edu/openlearn/whats-on/tv/ou-on-the-bbc-masters-money-keynes>

[https://www.youtube.com/watch?v=sd\\_FUexLSSQ](https://www.youtube.com/watch?v=sd_FUexLSSQ)



## Knowledge, application, analysis and evaluation

### Knowledge

**Key terms:** market economy, invisible hand, spontaneous order, command economy, mixed economy, central planning,

**Adam Smith** observed the early development of the Industrial Revolution in the late 18th century and wrote about a capitalist economy where small owner-managed firms were the norm. He was a firm believer in the benefits of *specialisation* and trade, observing that these two factors combined were responsible for economic growth and rising living standards.

Smith is associated with the metaphor of an *invisible hand* guiding consumers and producers in making decisions based on price signals they give to each other and which allocate resources in such a way as to produce goods and services that people want. Consumers bid up prices when something becomes popular and this signals to producers that they should produce more. Competition between producers incentivizes them to continually try and reduce costs and hence prices.

**Karl Marx** wrote in the mid-19th century by which time capitalism had evolved with limited liability companies separating the ownership and management of large firms and the rapid growth of these firms contributing to the emergence of monopoly power. Marx criticised capitalism arguing that it provided outcomes which denied workers a fair reward for their labour. He also felt that the cyclical nature of capitalism (booms and slumps) meant that workers, especially unskilled workers, bore the brunt of capitalism's downsides.

Marx felt that in the struggle between capitalist and labourer for the rewards of their efforts, labour and wages would be continually squeezed giving rise to organised labour movements which would wish to challenge the power of capital and strive to build a society based on common rather than private ownership of the factories and mines. His writings inspired 20<sup>th</sup> century political leaders such as Lenin in Russia and Mao in China where their successful political revolutions gave rise to planned economies which tried to replace the workings of the market.

**Friedrich Hayek** wrote in the 20th century very much as a reaction to the problems of planned economies (and the political tyranny which accompanied them). Horrified by the economic organisation of Communist Russia, Hayek put forward ideas which promoted the individual as the key economic decision-maker and argued against central planning. He believed that market prices reveal knowledge better than a central planner.

Hayek observed that an economy could not be planned in a scientific way, in the way that communists believed, because an economy is made up of millions of individual decision-makers each reacting to price signals in different ways and in doing so creating their own price signals. He argued that it would be physically as well as conceptually impossible to imagine that a central planner (even with computing power) would be able to understand these millions of individual decisions. A central planner should not even try and understand what consumers want because market prices themselves contain all the information required. If prices are allowed to convey information without government intervention they will create *spontaneous order* in markets which will ensure the most efficient allocation of resources.



Hayek is also famous for his disagreement with John Maynard Keynes over the most appropriate response to the Great Recession in the 1930s. Keynes saw a role for government in the management of the economy via changes in interest rates, taxes and spending. Hayek felt that such government intervention made things worse.

## Application

One way to compare market and command economies is to compare the fortunes of communist Russia and China with those of market economies.

### Russia

Communist Russia after 1917 gradually reduced the role of the market and brought more and more of the economy under the control of central planners. These planners did not use prices as their source of information when deciding what to produce.

A strength of central planning was that it enabled Russia to industrialise very rapidly and devote resources to the heavy industries which would enable the country to become a military power, capable of taking on and defeating a large part of the Nazi German war machine in World War 2.

Central planning also raised the basic education level of the Russian population and provided access to higher education to millions of Russians. It also achieved an improvement in health outcomes and had a very high ratio of doctors per head of population.

A weakness of central planning was that it went against peoples' desire to respond to market incentives and people had to be coerced (imprisoned and killed) to stop them from trading outside state sanctioned shops. Farmers, for example, were not allowed to sell their food in open markets but had to give their produce to the state at a price decided by a central planner. (Millions of farmers died in the 1930s as a result of their desire to trade in markets).

After World War 2, the United States and Western Europe experienced a phenomenal increase in living standards whereas communist Russia was unable to produce the goods people wanted or the quality they required. One of the last communist leaders, Mikhail Gorbachev, described his country as follows:

"Imagine a country that flies into space, launches Sputniks, creates such a defence system, and .... there's no toothpaste, no soap powder, not the basic necessities of life. It was incredible and humiliating to work in such a government."

Central planners set targets. Managers were incentivised to meet targets. Output targets meant that quantity was important but quality was neglected. The result was that Soviet industry produced large quantities of poorly made products. The managers would not be punished by consumers refusing to buy poor quality goods. They were punished instead by bureaucrats for failing to meet output targets.

Central planning proved to be incapable in providing for the needs and wants of its people and in 1989, this form of economic organisation came to an end (symbolised by the tearing down of the Berlin Wall).



## China

Chinese agriculture can provide an example of a transition from a command to a market approach.

After the communists came to power in 1949 until the 1970s, Chinese agriculture was organised into collective farms where farmers worked on state-owned land to produce food for the country. During the late 1970s Chinese agriculture moved from collective farms to individual farms where farmers were given long leases on individual plots and allowed to sell their produce privately.

The result of introducing market incentives was that food production increased and farmers' incomes grew. This increased production lifted hundreds of millions of people out of poverty. These agricultural reforms transformed the Chinese economy. Improved agricultural productivity meant that rural factories were set up, creating jobs for underemployed farm workers. China achieved growth rates of 8% per annum for 20 years and China's economy was transformed. The market had achieved what central planning could not and China achieved the biggest reduction in human poverty ever achieved in human history.



## Analysis

### The legacy of the three thinkers

Central planning essentially failed because it could not cope with the information flows necessary to allocate resources efficiently. As **Hayek** argued, markets convey information in a decentralised way through prices which provide signals to millions of decision makers (consumers and producers) about what to make and in what quantities. A government agency cannot do that. Knowledge in any economy is decentralised. Prices convey information from consumers to producers (and vice versa) and from producers to producers. A central planner cannot capture this knowledge.

In a centrally planned economy, planners set prices. These prices didn't fluctuate according to supply and demand so they were unable to deliver signals. Central planners (rather than entrepreneurs) made investment decisions but they had no signals to guide them.

Markets can convey knowledge through prices. People make choices based on prices. Prices rise and fall according to shortages and surpluses. **Adam Smith's invisible hand** provides us with a metaphor for a process which harnesses the knowledge conveyed by prices and consumers and producers respond accordingly. If a central planner tries to make decisions on behalf of the economy they will almost certainly get things wrong. In a market some firms will get things right and others will get things wrong. Those that get things right will be rewarded, those who don't will fail. Overall the result is better because those that get things right will survive and the reason they have survived is that they have produced a good or service that someone else was prepared to pay for. Resources have been used to produce something useful. In the Soviet Union resources were used to produce things which people did not want (massive surpluses) and failed to produce things which people did want (chronic shortages).

Marx criticised capitalism but those he inspired failed to create a better alternative.

Since 1945 there has been a tension in capitalist countries between those arguing for a greater, and those arguing for a lesser role for the state. This tension, in part at least, reflects the different approaches taken by Hayek and Keynes in their thinking about how to deal with the problems of capitalism. Their debate was about the extent of government intervention in the macro-economy.

There can also be debate about the role of the state in markets generally because markets cannot provide for all our needs. There are some goods which markets won't deliver at all (such as defence and law and order) or won't deliver in sufficient quantities (such as health, education and housing). This can lead to debates about the relative role of the public sector (government provision) and the private sector (market provision).



## Evaluation

The public v private question over provision is down to value judgements. For example, in health, making sure that spreadable diseases are controlled has a public aspect to it but cosmetic surgery is more private. In education, universal literacy is good for all (public), but a degree is of benefit to the individual (private) which suggests it should be paid for by the individual (although this point is also open to debate if you think about the arguments about tuition fees).

These value judgements influence how we feel about the size of the state. A minimal state may fail to fulfil some basic public good functions. A larger state may take on the production of goods and services which could be provided by the private sector in markets. Between the two extremes there is debate about the role of the state.

Much of the debate in this area is moral and political as well as economic. There is no one right economic viewpoint. It is probably fair to say that the legacy of Smith and Hayek is very strong in that capitalism is recognised as the best or 'least bad' system. The debate nowadays is really about how to make capitalism function better. For some, this can be achieved by a smaller role for the state and for others with a larger role for the state. Even those who might accept some of Marx's criticism of capitalism would not argue for the type of central planning which existed in communist Russia.

It is, however, too simplistic to see the debate in terms of markets vs government intervention, private vs public. Markets need the state to help them work effectively. The state has a role in a mixed economy. Spontaneous order works well with simple trade and exchange and with small firms. A modern economy with large corporations needs the state to help markets function effectively. Governments are important in making markets work properly:

- laws are needed to protect property rights and protect people from theft and fraud. For entrepreneurs to invest they need to be sure that their property rights will be respected and that they will be able to keep any profits they make from their enterprise. In countries where criminals or government officials have the power to seize assets or expect to be bribed the confidence of entrepreneurs will be reduced and this will reduce investment and hence economic growth.
- laws are needed to support contracts between buyers and sellers. In modern markets buyers and sellers may never build a personal relationship. As many transactions rely on deferred payments legal contracts can protect creditors (sellers). Buyers also need protection where goods are purchased before their quality can be tested.
- laws may be needed to reduce third-party effects (such as pollution, congestion)
- regulation is required to prevent sellers colluding and fixing prices
- regulation may be required where buyers do not have access to the same information that sellers have, or, to protect 'outsiders' from the activities of 'insiders' with more knowledge (e.g. managers who know more about what is likely to happen to the share price of their firm than shareholders)



- state provision of transport infrastructure helps reduce transport costs and helps firms operate more effectively
- state provision of social infrastructure (an educated and healthy workforce) helps reduce business costs and helps firms operate more effectively

The following activities may be useful or could be adapted to provide worksheets for students.



## Karl Marx (1818-1883)

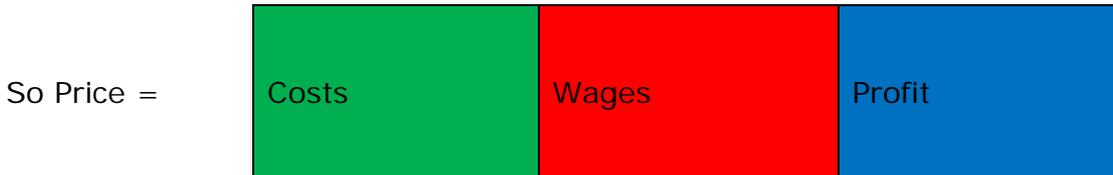
Karl Marx witnessed the development of the capitalist economy which resulted from the Industrial Revolution which Smith had observed at the end of the 18<sup>th</sup> century.

### Marx and the exploitation of the worker

Classical economists debated what determined the price of a product. For Marx:

Payment for the means of production	+	Payment to the worker	+	Payment to the capitalist (entrepreneur)	=	Price of the product
i.e. cost of raw materials and depreciation of the machinery	+	i.e. wages	+	i.e. profit	=	Price

Unlike other costs of production, Marx felt that labour was unique because the entrepreneur does not buy the worker but the worker's labour power or energy. It is this labour-power which adds value to the other inputs to bring about a price which is above the cost of the other inputs.



The impact of competition would be to reduce price and squeeze profits:



The entrepreneur would then have the incentive to reduce wages to maintain profits:



The entrepreneur would also have the incentive to become more capital intensive – replace skilled work with machinery which would also de-skill the worker:





The continual squeezing of workers' wages (as above) led Marx to predict that there would be a continual conflict between worker and capitalist and that this would lead to the end of capitalism.

Marx's theory only really works with unskilled workers. Increasing capital intensity tends to increase the productivity and wages of the remaining workers. Also, as firms grow they tend to take each other over, competition becomes less intense, and there is less of a squeeze on profits (and, therefore, wages).

Marx's thinking contributed to an ideology which inspired revolutionaries like Lenin in Russia and Mao in China to try and set up societies where the means of production were not owned by entrepreneurs but owned instead by the state on behalf of the workers, and where workers would be paid fairly, and more equally, for their labour. These **command economies** tried to use people (central planners) rather than markets (the invisible hand) to make decisions for consumers about what to produce.

## Marx, the division of labour and alienation

Adam Smith had described the division of labour and specialisation as the key to increased productivity and economic growth. Marx saw a downside. Specialisation would lead to boring and repetitive work and so workers became alienated from their work. Specialisation also led to de-skilling which weakened the bargaining power of the individual worker and their ability to command a high wage.

## Marx and economic cycles

Marx challenged the idea that capitalism was stable. Classical economists tended to believe that a free market economy is always either in, or moving towards, equilibrium. Recessions were not possible because markets always adjust. Marx argued that capitalism was cyclical – there is no equilibrium.

Growth leads to more jobs and lower unemployment. This encourages workers to demand pay rises which reduces profits. Lower profits reduce the level of investment which in turn reduces growth.

Reduced or negative growth increases unemployment and workers have to accept lower wages. These lower wages restore profit levels and so investment rises leading to more growth and jobs.

This idea of cycles has since been taken up by other (non-Marxist) economists.

## Questions

1. Explain why, according to Marx, workers would be continually exploited in a capitalist (market) economy.
2. Discuss the benefits and drawbacks of increased specialisation for the individual worker, and for society.



## Adam Smith (1723-1790)

### Adam Smith and the division of labour

Smith felt that specialisation and the division of labour was responsible for the economic growth taking place during the Industrial Revolution. As firms grew, they could divide up each job into smaller sub-tasks so that work was more and more specialised. Greater specialisation allowed for lower production costs and allowed firms to grow even bigger.

His most famous example is his description of what he had observed in a **pin factory**:

"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 particular business, to whiten the pins is another ... and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which in some manufactories are all performed by distinct hands, though in others the same man will sometime perform two or three of them."

The idea of specialisation is not only important within a business but also within the economy.

### Adam Smith and the Invisible Hand

"Every individual...generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. ....He is in this, as in many cases, led by an *invisible hand* to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good." (From *The Wealth of Nations*, 1776)

Adam Smith explained the workings of the market economy with his analogy of the 'invisible hand'. Self-interested behaviour by consumers and producers leads to the best outcome for society. Market forces drive scarce resources towards the uses that consumers want. Millions of consumer and producer decisions are made every day and these decisions influence how resources are allocated. This process does not require any central direction. In fact it is a process which no central planner could undertake.



## Activity: I, Pencil

The essay, I, Pencil, was written in 1958 by Leonard E. Read.

Either read the essay: <http://www.econlib.org/library/Essays/rdPncl1.html>

Or, watch this film: <http://ed.ted.com/on/8S6Mp7EP>

Explain how the story of the pencil illustrates:

- The division of labour
- The invisible hand or spontaneous order

## Activity: eBay

Auction site eBay uses open auctions where bidders bid for an item and can see what other bidders are offering. A bid represents the bidder's estimate of the value of an item and the winning bid reflects the value placed on the item by all the losing bids.

For convenience, auctions are time limited. This means that as a bidder you don't have to sit and watch what is happening. You can join in as the time approaches the cut-off point.

Once an auction is finished, eBay asks buyers to rate sellers. Sellers with a good score may well attract a higher price.

### Research

Investigate eBay auctions from the point of view of buyer and seller. (If you have never used eBay, try and talk to someone who has).

1. Explain how auction prices convey information.
2. Explain why this method of price setting is preferable to a system where a central planner might decide on the exchange price for everything.
3. Explain the 'trust' problem implicit in an eBay transaction.
4. Discuss how the 'trust' problem can be overcome.

eBay auctions operate within a set of rules. Find out what these rules are.

5. Discuss how these rules help this market work more effectively.
6. To what extent does an eBay auction illustrate the working of an *invisible hand*?