

Definition of economic system

An economic system is the organized way in which a country handles its economic decisions and solves its economic problems. It is how a country makes its earning and spending decisions.

No two economic systems are exactly alike. Each country is unique; some focus on tradition, others emphasize government control, and still others value an open market.

Basic elements in economic systems

The following elements are found in all economic systems:

- **Resources**
 - Natural resources, human resources, and capital goods
- **Markets**
 - The arrangements for buying and selling goods and services
 - Economic markets are made up of both buyers and sellers.
- **Participants**
 - Producers (make or provide goods and services), consumers (purchase products), and government (makes and enforces the country's laws)
- **Medium of exchange**
 - Something of value that can be used to obtain goods and services; money

Reasons that economic systems are needed

Every country must make economic decisions about what to do with its resources for the following reasons:

- **Our wants are unlimited, but our resources are not.**

Because of this, governments must make decisions about what can be produced, how much can be made, and who can obtain the products.
- **People in all economic systems are interdependent.**

We depend on each other to obtain the things we need. Economic systems provide a way for this to happen by coordinating the activities of producers, consumers, and governments.

Major types of economic systems

Although there are some basic types of economic systems, they each contain some elements of the others.

Traditional economic systems

- Controlled by **traditions**
- Require few economic decisions to be made but those decisions are based on habits, customs, and beliefs
- People learn their parents' trade and produce the same products in much the same way.
- Called subsistence systems since people's level of existence barely supports life
- People consume all that they produce to satisfy their basic needs for food and shelter.
- Some tradition is part of all economic systems, but it is the major characteristic of traditional systems.
- Examples: villages in the Andes Mountains, Amazon Rainforest communities, the Aborigines of Australia, and rural areas in Africa

Command economic system

- Named "command" because a small group of people is in command of all the others
- A basic characteristic: government ownership and operation of many or all of the means of production and distribution
- Play key role in economic planning and decision-making
- Has limited consumer influence
- Has limited or no competition.
- Two primary types of command economic systems.

Communism

- Government owned and controlled means of production and distribution
 - Does all of the economic planning (called central planning)
 - Makes all economic decisions
 - Controls the economic system
 - Sets wages people earn and prices they pay based on the amount of labor required to produce the item
 - Tells workers where to work and what they are to do at work
 - Sets quotas for the amount of work businesses are to produce
 - Permits people to own some personal property but does not allow them to invest in the economy
- Capital for business investment provided by the government from taxes and from the profits of state-owned businesses

- Historic examples: The Soviet Union and China.
 - The Soviet Union dissolved.
 - China's economy becoming more market-oriented
- Current day examples: Cuba and North Korea

Socialism

- Combines government and private ownership
 - Government ownership of some basic means of production
 - Private ownership of businesses
- Allows capital for business investment to come from private and public business profits and from government bonds
- Allows workers to choose where to work
- Guarantees jobs for their citizens and provides financial assistance to businesses to keep workers on the job in many socialist countries
- Sets workers' pay based on the value of the work to society
- Often called welfare states because their programs provide citizens with free medical care, education, welfare, and other benefits
- Charges high taxes to pay for these programs
- Examples of socialist countries: Canada, Sweden, and Great Britain
 - Sweden has experimented with lower taxes to give its citizens more purchasing power.
 - Great Britain has privatized many of its state-owned industries.

Market economic systems

- Individuals and businesses own the means of production and distribution.
- Limited government control of business
- Active competition for sales and profits among businesses
- Allows people to live and work where they choose
- Allows people to start their own businesses
- Allows businesses to use their wages or profits as they like
- The market allocates resources.
 - Producers use resources to make whatever customers want and are willing to buy.
 - Supply and demand control prices.
 - Producers seek cost-effective methods of production to maximize profits.
- The economic activity in market economy moves in a continuous circle. People work to earn wages which they use to purchase goods and services. These sales provide profits to producers, who provide more products. This cycle repeats itself over and over.

- Examples include Japan, India, and the United States.
 - Their citizens are free to live and to work where they choose, to use their incomes as they wish, to compete with others, and to own private property. People are free to make their own economic decisions so long as they are within the law.
- Government regulates the economy but does not control it.
 - Refrains from telling producers and consumers what to do in the U.S.
 - Enacts and enforces consumer safety regulations, labor laws, and other directives that businesses must follow.
 - Works to lessen the effects of economic problems such as recessions or market failures.
 - Maintains order through the legal system
 - Produces public goods and services including postal service, education, and defense
 - Consumes items such as paper goods, cars and trucks, and military items

The basic economic questions that economies must answer

What will be produced?

- The first economic decision to be made
- Affected by profitability, consumer demand, and resource availability

How will products be produced?

- The next economic decision to be made--what methods of production to choose
- Involves determining which resources to use, which technologies to employ, and what production methods are most efficient

How will products be allocated?

- The last economic decision to be made
- Must decide who gets its goods and services
 - Price?
 - Income?
 - Government rationing?

The way each economic system answers these economic questions is affected by each country's government. In some countries, government runs the country and makes economic decisions. In other countries, government runs the government and allows individuals to make economic decisions.

How do traditional economies answer the economic questions?

What will be produced?

- The same things that were produced by ancestors
- The items are needed to carry on people's daily lives

How will products be produced?

- By ancestors' methods

How will products be allocated?

- Everything produced in the community is consumed by the community. There are no incomes, prices, or markets to consider.

How do communist command economies answer the economic questions?

What will be produced?

- Government determined based on its production plans of what the government wants rather than on consumer need

How will products be produced?

- Government decided
- Tell businesses what methods, workers, and factories to use

How will products be allocated?

- Government determined since it also decides what jobs workers do and what incomes workers receive
- Often experience short supply of consumer goods

How do socialist command economies answer the economic questions?

What will be produced?

- Government planned, but with consideration for supply and demand
- Planners decide whether to expand current production or save profits for future expansion.

How will products be produced?

- Government and private business determined

How will products be allocated?

- Consumers' incomes determine what they can buy. People can choose what work they do, but wages are set according to what the government feels is the value of the work to society. As a result, government influences workers' incomes and their ability to purchase.

How do market economies answer the economic questions?

What will be produced?

- Consumer determined by casting economic votes through their purchases
- Deciding factor: price
- Producers strive to produce profitable goods and services that consumers want to buy.

How will products be produced?

- Those that enable offering products at prices that are attractive to consumers
- Competition determined since producers try to use resources as efficiently as possible to compete with other producers and to maximize profits.

How will products be allocated?

- Income determined since a person's income level determines what s/he can purchase
- Since income is based on the resources the consumer owns and supplies to the marketplace, people with highly valued resources have higher incomes with which to buy more or higher priced products.

Problems associated with economic systems

With traditional economies:

- Little opportunity for growth or improvement
- Few new ideas are accepted; new technology shunned because it is different.
- No savings since people consume all they produce
 - Without savings, people cannot invest in greater production. and are never able to raise their economic standards.

With communist command economies:

- **Theory:** People would eventually own everything, government control would not exist, everyone would perform the work that s/he does best, and everyone would be paid according to what s/he needs.
- **Reality:** Communist governments control their economies and their people.
- Many focus on producing industrial goods rather than supplying sufficient consumer goods; consumer goods are often poor quality because the government pays workers based on the quantity, not the quality, of what they produce.
- Inefficient production because businesses are not allowed to find better methods of production; must do exactly what the government tells them to.
- Little workers can do to help themselves since the government determines what type of education they receive, what type of job they have, and where they live. The government directly impacts what people can purchase since it determines their income.

With socialist command economies:

- Levy high taxes to pay for their many human-services programs
- Less money for people to spend
- Charge higher prices that can result in fewer sales
- Requires privately-owned businesses to follow the state's master plan for the business or industry which may result in less efficient production
- Allows workers to choose their jobs
- Encourages certain types of employment and discourage others Workers paid according to the value of their work in the eyes of the government, rather than according to their ability and skill

With market economies:

- Allows people to run the risk of financial loss if their business is unsuccessful
- Fines businesses that do not follow government regulations for their businesses
- Requires fair competition—some businesses may try to capture the entire market for a product by attempting to control its price, output, and employment in the field. Other businesses may try to compete by producing cheaply made products.
- Incomes based on unequal factors such as demand for a particular skill and the scarcity of that skill
- Unequal incomes; people with higher incomes can afford higher priced products.