Who's the Boss?

Economic Systems

Traditional Socialist Command
Communist Command Market

What you can do
Calling the shots
Do you have a problem?
Regardless of race, gender, or religion, just about everyone belongs to some type of family unit. This family unit might be a traditional one, or it might be completely unconventional. Some family units are related to each other by blood, some are a close-knit circle of friends, and some are simply people who live together or share common values. Think for a minute about your own family unit. How would you describe it? How is it similar to or different from others in your community?

In spite of their differences, practically all family units have one thing in common: They must decide how they will obtain income and how that income will be spent. Countries are in the same situation. No two nations are exactly alike, but they all must decide what their resources are, what they can produce, and who will get the items that are produced. How does a country make these decisions? It all depends on the country’s economic system.

No two nations’ economic systems are exactly alike. Each country has its own unique economic system. Some focus on tradition, others emphasize government control, and still others value an open market. Nevertheless, there are certain elements found in all economic systems. These are:

- **Resources**
  Economic resources include natural resources, human resources, and capital goods—manufactured or constructed items used in production.

- **Markets**
  Markets are arrangements for the buying and selling of goods and services. Economic markets are made up of both buyers and sellers.

- **Participants**
  Participants include producers, consumers, and government. Producers make or provide products, consumers purchase products, and government makes and enforces the country’s laws.

- **Medium of exchange**
  A medium of exchange is something of value that can be used to obtain goods and services. The most common medium of exchange is money.
Why Do We Need Economic Systems?

Ideally, we would not need economic systems. Every person would produce or purchase everything that s/he wanted. Unfortunately, real life doesn’t work that way. Every country must make economic decisions about what to do with its resources. Why is that? Let’s find out.

- **Our wants are unlimited, but our resources are not.** No country has enough resources to supply everything that its people want or need. So, choices must be made. One of the functions of an economic system is to 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. The economic system provides a way for this to happen. It coordinates the activities of producers, consumers, and government. For example, you may be skilled in web design but not in automotive repair. When you need new brakes for your car, you don’t install them yourself. You use part of your earnings to hire a car mechanic. In turn, when the car mechanic wants a web site for his/her business, s/he uses the profits from fixing your brakes to pay you to build a business web site for her/him.

Economic Systems from Around the World

We can divide economic systems into basic types, although each economic system contains some elements of the others. For instance, the United States has a market economy in which individuals and businesses own and control most of the means of production and distribution. However, our economy is not a pure market system because our government produces some goods and services, such as roads, the postal service, education, and defense. Let's take a look at the major types of economic systems and their basic characteristics.

**Traditional economic system.** This economic system is based on traditions passed down through the generations. Few economic decisions need to be made, but those decisions are based on habits, customs, and beliefs. Rather than choosing her/his own job, each person in a traditional economy learns his/her father’s or mother’s trade and produces the same products as prior generations of the family did, in much the same way.

A traditional economic system is sometimes called a subsistence system. Subsistence is a level of existence which barely supports life. People in a traditional system consume all that they produce in an attempt to satisfy their basic needs for food and shelter.

Some tradition is part of all economic systems, but it is the major characteristic of a traditional system. Examples of traditional economies include villages in the Andes Mountains, Amazon Rainforest communities, the Aborigines of Australia, and rural areas in Africa.

**Command economic system.** This system gets its name because a small group of people is in command of all the others. A basic characteristic of a command economic system is that the government owns and operates many or all of the means of production and distribution. Government plays a key role in economic planning and decision-making. The influence of consumers on economic decisions is limited, and there is little or no competition. The two primary types of command economic systems are communism and socialism.

- **Communism**
  
  In a communist command economy, the government owns and controls practically all of the means of production and distribution. The government does all of the economic planning (called central planning), makes all economic decisions, and is in control of the economic system.
People are permitted to own some personal property in a communist system, but they are not allowed to invest in the economy. Capital for business investment is provided by the government. This capital comes from taxes and from the profits of state-owned businesses.

Communist governments set the wages that people earn and the prices that people pay. Workers are told where to work, what they are to do at work, and what wages they are to be paid. To determine the price of a product, the government calculates the amount of labor required to produce it. Assume that it takes three hours to make a dress and six hours to make a suit. In a communist economy, the suit would cost twice as much as the dress.

Communist governments set production quotas for their businesses. These quotas are often high. Nevertheless, businesses are expected to reach them. And, if they reach their quotas, government rewards them with higher quotas for the following year.

Two of the most famous communist systems in history were the Soviet Union and China. However, the Soviet Union and its communist economy dissolved in 1991. Communism is also starting to disappear in China, where the economy has become much more market-oriented in recent years. Two of the best present-day examples of communist economies are Cuba and North Korea.

### Socialism

In socialist command economies, government owns some basic means of production (think banks, energy, and communication), but there is private ownership of business as well. Capital for business investment comes from private and public business profits as well as from government bonds.

Workers in socialist economies are free to choose where to work. Many socialist countries guarantee jobs for their citizens and provide financial assistance to businesses to keep workers on the job. Socialist governments also set the pay for these workers. They base workers' wages on their judgment of the value of the work to society.

Socialist countries are often called welfare states because their governments have programs to provide citizens with free medical care, education, welfare, and other benefits. To pay for these programs, the government charges higher taxes.

Classic examples of socialist economic systems include Canada, Sweden, and Great Britain. Sweden, however, has experimented with lower taxes in recent years to give its citizens more purchasing power. And, in the last couple of decades, Great Britain has privatized many of its state-owned industries.

### Market economic system

In a market economic system, individuals and businesses own the means of production and distribution. Government control of business is limited, businesses actively compete for sales and profits, and people live and work where they choose. Individuals can start their own businesses, and they can use their wages or profits as they like.
The allocation of resources in a market economy is controlled by the market. Producers use resources to make whatever customers want and are willing to buy. Prices are controlled by supply and demand rather than being set by government. To maximize their profits, producers seek out cost-effective methods of production.

The activity in a 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 in turn provide more products. This cycle repeats itself over and over.

The United States, Japan, and India are market economies. 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.

In market systems, government regulates the economy but does not control it. In the U.S., our government generally refrains from telling producers and consumers what to do. However, our government enacts and enforces consumer safety regulations, labor laws, and other directives that businesses must follow. Our government also works to lessen the effects of economic problems such as recessions or market failures. Our legal system maintains order, and the government produces public goods and services including the postal service, education, and defense. Lastly, our government consumes items such as paper goods, cars and trucks, and military items.

**Summary**

Economic systems are the organized ways in which countries handle their economic decisions and solve their economic problems. Each economic system contains resources, markets, participants, and a medium of exchange. Economic systems are needed because no country has enough resources to supply everything its people want or need and people are interdependent. The major types of economic systems are traditional, command (divided into communism and socialism), and market.

1. What is an economic system?
2. Explain the four basic elements of all economic systems.
3. What are two reasons why we need economic systems?
4. Describe the basic characteristics of traditional economies.
5. Distinguish between the two types of command economic systems.
6. What are the distinguishing characteristics of a market economic system?
Now that we know what economic systems are and why they are needed, we need to understand the basic economic questions they must answer and the ways in which they go about answering these questions. The questions are:

- **What will be produced?**
  This question must be answered before making any other economic decision. Resources can be turned into a variety of products depending upon the economic system’s goals. Factors that affect the decision may include profitability, consumer demand, and resource availability.

- **How will products be produced?**
  After deciding what to produce, methods of production must be chosen. This involves determining which resources to use, which technologies to employ, and what production methods are most efficient.

- **How will products be allocated?**
  Each system must decide who gets its goods and services. In some systems, price determines who gets what since income determines what the consumer is able to buy. In other systems, government rations products among citizens.

The way in which each economic system answers these economic questions is affected by each country’s government. In some countries, government not only runs the country but also makes economic decisions. In other countries, government runs the country and allows individuals to make economic decisions. Let’s see how the basic economic questions are answered in each system.

**Traditional Economies**

Traditional economic systems answer the basic economic questions in the following way:

- **What will be produced?**
  People living in a traditional economy produce the same things that were produced by their ancestors. The items they produce are what they need to carry on their daily lives.

- **How will products be produced?**
  People in a traditional system use the same methods of production as their ancestors. They pass these methods down to their children. If a hunter learned to hunt using a bow and arrow, for instance, he will teach that method to his son.

- **How will products be allocated?**
  People in a traditional economy use some of what they produce and share the rest with their community. Everything that is produced by the community is consumed by the community. There are no incomes, prices, or markets to consider in a traditional economic system.

**Communist Command Economies**

Communist command economic systems answer the basic economic questions in the following way:

- **What will be produced?**
  Government owns the country’s resources and decides how those resources will be allocated. The government determines what will be produced. It bases its production plans on what it wants rather than on consumer need.
World Economies

Market Economies

Market economic systems answer the basic economic questions in the following way:

• How will products be produced?
  Consumers decide what will be produced by casting economic votes through their purchases. Price is the deciding factor. Producers strive to produce profitable goods and services that consumers want to buy.

• How will products be produced?
  Government decides how to distribute products because it also decides what jobs workers do and what incomes workers receive. Consumer goods are often in short supply.

Socialist Command Economies

Socialist command economic systems answer the basic economic questions in the following way:

• How will products be produced?
  Since the government is the major producer in a communist system, the government decides how to produce products. Business is told what methods, workers, and factories to use.

• How will products be allocated?
  Government decides how certain basic products are produced. Other production decisions are made by private businesses.

• 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 will products be allocated?
  Income determines who gets what in a market economy. Each 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.

What’s the Problem?

Countries cannot exist for long without economic systems. However, there are no perfect systems. Each system has certain problems.

Traditional economies. The major problem for a traditional economic system is that there is little opportunity for growth or improvement. Few new ideas are accepted, and new technology is shunned because it is different. The people consume everything that they produce, so they are never able to save anything. Without any savings, they cannot invest in greater production. As a result, they are never able to raise their economic standards.

Communist command economies. There are many problems in communist command economies. In theory, people in a communist country would eventually own everything, government control would not exist, and everyone would perform the work that s/he feels is the value of the work to society. As a result, government influences workers’ incomes and their ability to purchase.
Many communist governments focus on the production of industrial goods rather than consumer goods. The few consumer goods that are available are often poor quality because the government pays workers based on the quantity, not the quality, of what they produce. Also, production is often inefficient because businesses are not allowed to find better methods of production. Instead, they must do exactly what the government tells them to do.

There is little that workers can do to help themselves in a communist economy. The government determines what type of education a person receives, what type of job s/he has, and where s/he lives. Because the government determines each person’s income, it directly impacts what each person can purchase.

**Socialist command economies.** To pay for their many human-services programs, socialist governments levy high taxes. Because of these high taxes, individuals have less money to spend. Businesses charge higher prices, which can result in fewer sales.

Privately owned businesses cannot compete with state-owned businesses in a way that would be most beneficial to them. Instead, they must follow the state’s master plan for the business or industry. In some cases, this results in less efficient production.

While socialist workers are free to choose their jobs, the government does encourage certain types of employment and discourage others. Workers are paid according to the value of their work in the eyes of the government, rather than according to their ability and skill.

**Market economies.** Market economies also have their share of problems. People are free to go into business for themselves, but they run the risk of financial loss. In addition, they may experience legal problems if they do not follow government regulations for their businesses.

Competition is a source of problems. A business may try to capture the entire market for a product by attempting to control the price, output, and employment in the field. Other businesses may try to compete by producing cheaply made products.

Finally, because incomes are based on unequal factors such as demand for a particular skill and the scarcity of that skill, some individuals’ incomes are higher than others. Only those people with higher incomes can afford higher priced products.

**Summary**

There are three basic economic questions which each economic system must answer. These questions focus on what will be produced, how products will be produced, and how products will be allocated. Each economic system answers these questions in a different way. While most countries could not function without an economic system, every economic system has its problems.

1. What are the three economic questions that all economic systems must answer?
2. How do traditional economic systems answer the economic questions?
3. How do communist command economies answer the economic questions?
4. How do socialist command economies answer the economic questions?
5. How do market economic systems answer the economic questions?
6. Explain two problems each of traditional, communist command, socialist command, and market economies.