

Who's the Boss?

Economic Systems

Objectives:

- A** Distinguish among types of economic systems.
- B** Explain how each of the economic systems answers the basic economic questions.



1375 King Avenue, P.O. Box 12279, Columbus, Ohio 43212-0279

Ph: (614) 486-6708 Fax: (614) 486-1819

CopyIT!® Details: www.MBAResearch.org Copyright ©2016
by MBA Research and Curriculum Center®

Table of Contents

A	Economics: A Systematic Approach	2
B	Do You Have Any Questions?	12
So?	What? Why bother learning about economic systems?	2
THE GRAY ZONE	What would you do?	9
Make It Pay!	Use what you've learned—right now!	19

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.

Economics: A Systematic Approach

An **economic system** is the organized way in which a country handles its economic decisions and solves its economic problems. In other words, it's the way in which a country makes its earning and spending decisions.



▲ You may know that countries use different currencies, but there are many other aspects of the economy that vary between nations, too.

No two nations' economic systems are exactly alike. 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 (including entrepreneurship)**, 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.

- ▶ *Using money as a medium of exchange is much more convenient than trading goods and services directly. Imagine trying to pay for a haircut using food or clothes—it just wouldn't work!*



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. Choices must be made. One of the functions of an economic system is to provide the framework for making 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 website for his/her business, s/he uses the **profits** from fixing your brakes to pay you to build a business website.

- ▶ *Economies thrive on the interactions between producers and consumers, such as a web designer and a mechanic. Economic systems allow these connections to happen.*



Wavebreakmedia Ltd/Wavebreak Media/Thinkstock

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. Some tradition is part of all economic systems, but it is the major characteristic of a traditional system. 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 that 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.

Examples of traditional economies include villages in the Andes Mountains, Amazon Rainforest communities, the Aborigines of Australia, and rural areas in Africa.

For more information about traditional economies, including examples and activities, visit "Traditional Economies and the Inuit" by EconEdLink: <http://www.econedlink.org/lesson/795/undefined>.

- ▶ *A fisherman in a traditional economic system will teach his children methods of fishing that have been passed down in his society for generations.*



Marcin Kirsz/Stock/Thinkstock

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. **Financial 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 tell workers what to produce and how to produce it.*

Communist governments also set production **quotas** for their businesses. These quotas are often high. Nevertheless, businesses are expected to reach them. If they reach their quotas, the 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. Two of the best present-day examples of communist economies are Cuba and North Korea, although in the past few years, Cuba has also begun economic reforms that will reduce state ownership and introduce a private sector.



Check out the interactive timeline “U.S.-Cuba Relations” by the Council on Foreign Relations to see the history of Cuba’s economy and how interactions with the United States have changed over the years:

<http://www.cfr.org/cuba/timeline-us-cuba-relations/p32817>.

- **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, financial assistance, and other benefits. To pay for these programs, the government charges higher taxes.

Classic examples of socialist economic systems include Canada, Sweden, and Denmark. Sweden, however, has experimented with lower taxes in recent years to give its citizens more purchasing power. Many European countries, such as Great Britain, Ireland, and France, mix elements of socialist and market economies.



Like communist economic systems, socialist governments actively participate in the economic planning process. However, unlike communist central planners, socialist governments allow buyers and sellers in open markets to make economic decisions as well.

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 the government. To maximize their profits, producers seek out cost-effective methods of production.

THE GRAY ZONE

Members of some market-oriented and command economies seem to pity or look down upon people living in traditional systems. These individuals say that traditional cultures are backwards, underprivileged, suffering, and living in the past. Armed with such beliefs, many “modern” societies dedicate themselves to introducing their lifestyles, technology, and economic systems to the more traditional groups.

While some traditional economies embrace the opportunity to grow and “evolve,” others do not. People in some traditional economic systems are not interested in changing. They are happy to live much as their past generations have lived, they enjoy being part of a very close-knit community, and they respect the traditions and beliefs of their ancestors.

Should market-oriented and command governments encourage people in traditional economies to adopt their ways? Do these traditional systems need help? Or does outside assistance do more harm than good for these societies?

The activity in a market economy moves in a continuous circle. People work to earn wages that 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.

Profit is the ignition system of our economic engine.

—Charles Sawyer, American photographer

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



- ▲ *Do you have a great idea for the next big thing? In market economies, people are free to open whatever businesses they want—as long as consumers are willing and able to purchase their products.*



The video “Types of Economic Systems” by UniversityNow provides a clear and simple explanation of the various types of economic systems: <https://www.youtube.com/watch?v=5xgwYRX19VU>.

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.

TOTAL RECALL

1. What is an economic system?
2. Explain the four basic elements of all economic systems.
3. Are economic systems necessary? Why or why not?
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?

Do You Have Any Questions?

Now that we know what economic systems are and why they are needed, we need to understand the basic economic questions they must answer.

- **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.

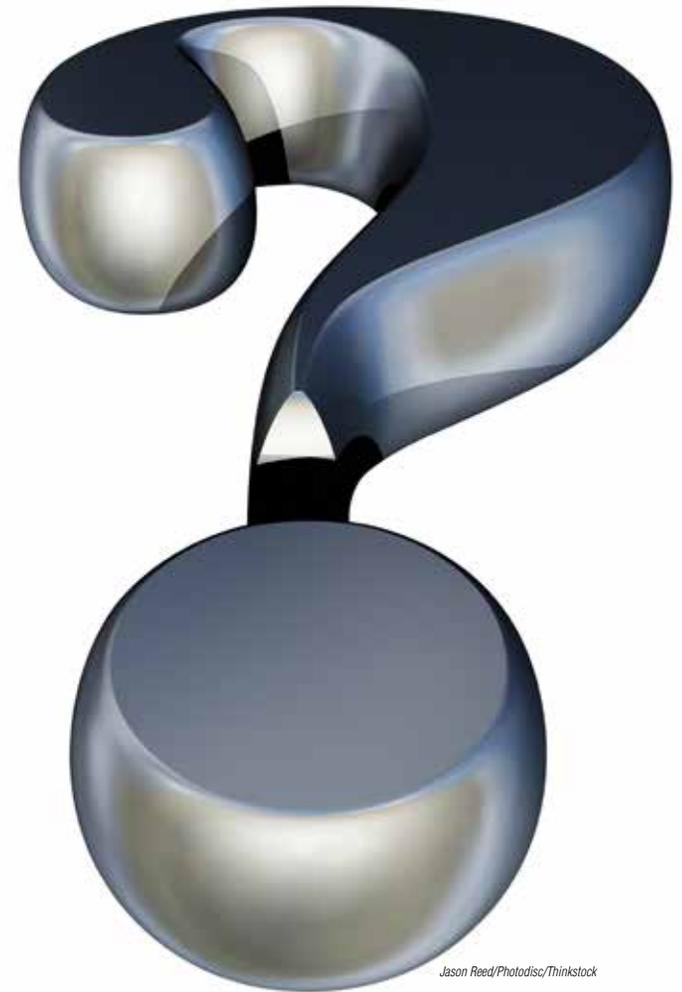
- **How will products be produced?**

After deciding what to produce, methods of production must be chosen. This involves determining which resources to use, which technologies to employ, and which 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. Let's see how the basic economic questions are answered in each system.



Jason Reed/Photodisc/Thinkstock

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 needed 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 children.

- **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.

- ▶ *Some traditional production methods may seem inefficient by modern standards, but people in traditional economies have developed the necessary skills to keep their societies functioning for generations.*



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.

- **How will products be produced?**

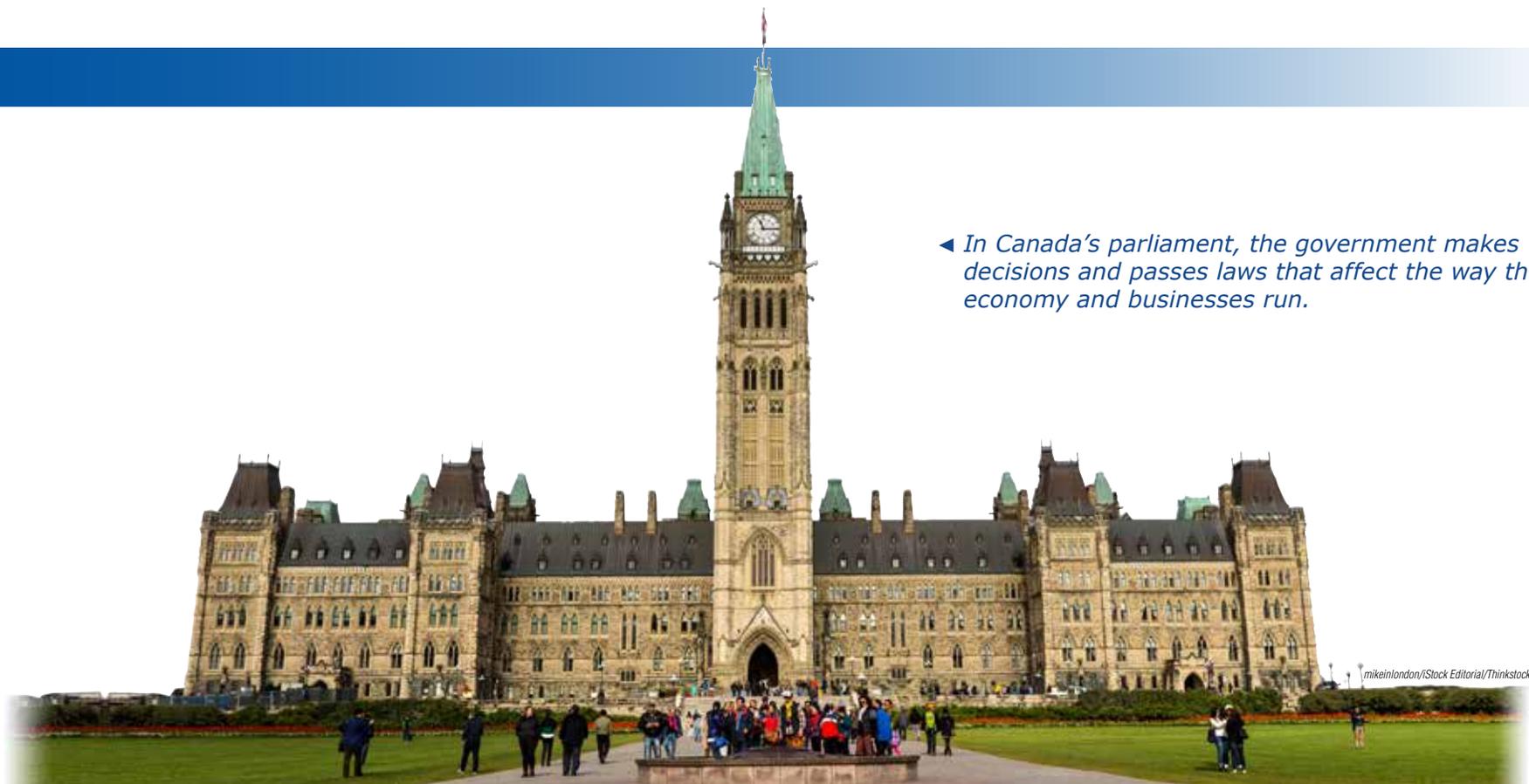
Since the government is the major producer in a communist system, the government decides how to produce. Businesses are told what methods, workers, and factories to use.

- **How will products be allocated?**

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 because resources are used to support government efforts such as the military or industrialization.

- ▶ *Factories in communist countries are owned, controlled, and used by and for the government.*





◀ *In Canada's parliament, the government makes decisions and passes laws that affect the way the economy and businesses run.*

Socialist Command Economies

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

- **What will be produced?**

Planning is done by the government, but supply and demand are taken into consideration. Planners decide whether to expand current production or save profits for future expansion.

- **How will products be produced?**

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 the value of the work to society, as determined by the government. As a result, government influences workers' incomes and their ability to purchase.

Market Economies

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

- **What will 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?**

Producers use production methods that enable them to offer products at prices which are attractive to consumers. Competition is an important factor. Each producer tries to use resources as efficiently as possible to compete with other producers and maximize profits.

- **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.



Ablesstock.com/Ablesstock.com/Thinkstock

▲ *In the United States, people place a high value on successful surgical procedures, so surgeons receive high incomes. What other resources are highly valued in market economies?*



To learn more about the ways in which each economic system answers the basic economic questions, read the article "Comparative Economic Systems" by Bill Jackson: http://www.socialstudieshelp.com/Economic_Systems.htm.

What's the Problem?

Economic systems are necessary, but 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.

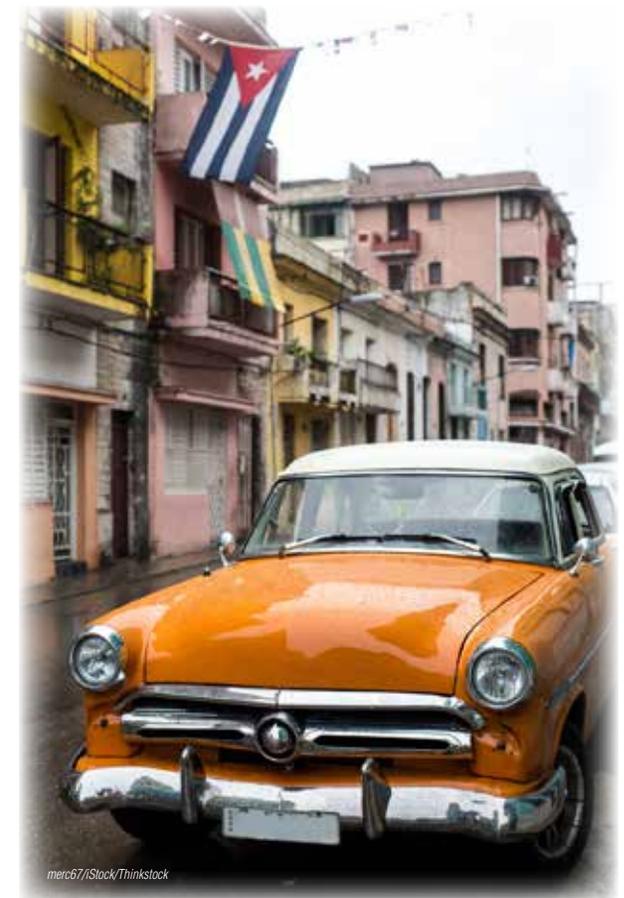
Communist command economies. There are many problems in communist command economies. In theory, people in a communist country would eventually own everything, government control would not exist, everyone would perform the work that s/he does best, and everyone would be paid according to what s/he needs. In reality, though, communist governments control their economies. When a government controls its economy, it controls its people as well.

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.

- ▶ *In the last several decades, Cuba's communist government has not invested in developing or buying new cars for consumer use. Therefore, many people in Cuba drive antique cars from the 1940s and 1950s.*

The economic development of communist command economies is usually behind that of market economies.



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.



More details and examples about the strengths and weaknesses of a market economy can be found in the article "Free Markets: What's the Cost?" by Chris Seabury: <http://www.investopedia.com/articles/economics/08/free-market-regulation.asp>.



Summary

There are three basic economic questions that 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.

TOTAL RECALL

1. How do traditional economic systems answer the economic question, “What will be produced?”
2. How do communist command economies answer the economic question, “How will products be produced?”
3. How do socialist command economies answer the economic question, “How will products be allocated?”
4. How do market economic systems answer the economic question, “What will be produced?”
5. Explain two problems each with traditional, communist command, socialist command, and market economies.

Make It Pay!

What extracurricular activities do you participate in? How would you describe the economy of each? Are decisions made according to what has been done in the past, as in a traditional system? Do the organizations’ leaders make all necessary decisions for you, like communist governments? Do you and the leaders share responsibility for decision making in a way that’s similar to socialism? Or do the organizations act like market economies, allowing individual members to call most of the shots?