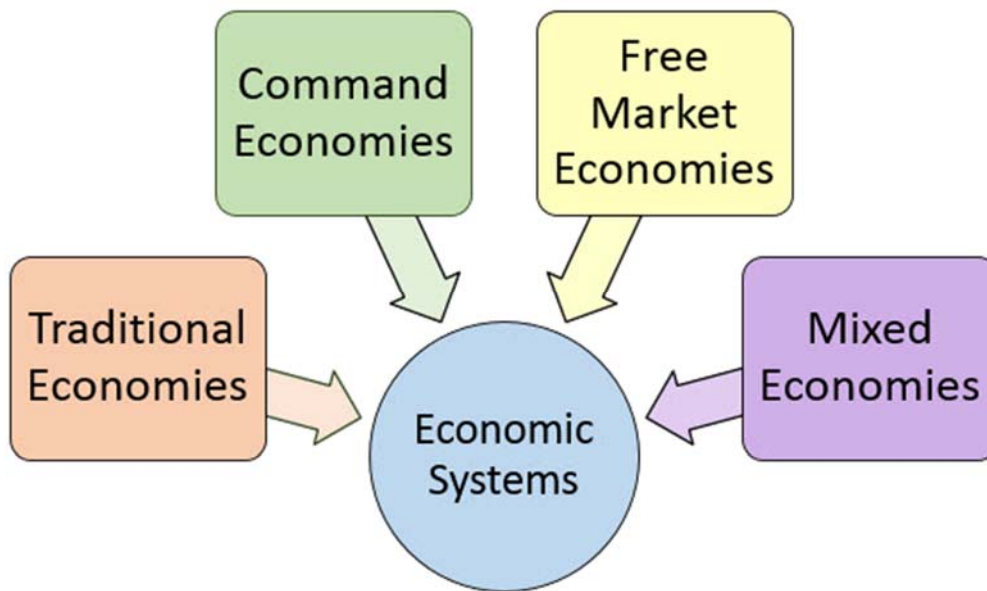


# ECONOMIC SYSTEMS

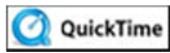


## Unit Overview

Because a society's survival depends on allocating limited resources to meet people's needs, it must decide what, how and for whom to produce. Therefore, countries have developed organized ways to provide for their populations. This has resulted in specific collections of traditions and rules known as economic systems. Every society shapes its economic system based on resources, needs, wants, goals and values. Although they are described as traditional, command or market economies, no single, economic system has all the right answers. For this reason, nations have adopted features of each of them to form mixed economies. Most countries in the world, however, emphasize one style more than the others. Let's see how it all works.

## Economic Systems

Since resources are always scarce, nations, like individuals, make **trade-offs** that result in **benefits** and **opportunity cost**. Remember—they must decide what to produce, how to produce and for whom to produce goods and services based on their available resources and on the needs of their populations. Every society determines the answers to these questions according to their own **goals and values**. Because resources are scarce, countries establish priorities and often pursue some goals at the expense of others. To deal with this process, organized ways to meet wants and needs on a national scale emerged. These sets of rules are called **economic systems**, and they fall into four, broad categories: traditional, command, market and mixed. Learn more about economic systems and how they developed by viewing the video listed below.



Economic Systems



Go to Questions 1 and 2.

## Traditional Economies

Some societies rely on customs, rituals and/or habits when they answer the three basic questions concerning production. This results in what are known as **traditional economies**. They sometimes rely on barter rather than money and use nearly all that they produce. Little or nothing is left to encourage trade. Because it is intent on preserving tradition, this type of economy shows little interest in new ideas or innovative technology. Generally, traditional economies are found in rural areas that depend on agriculture and/or hunting for survival. People are defined by strict roles, and there is little tolerance for change. Boys usually adopt the same occupations as their fathers; girls follow the examples established by their mothers. Although some people view this as a disadvantage, others regard it as a positive aspect of this type of economy. Everyone knows exactly what is expected of them. Therefore, there is no stress over what to produce or how to produce it because every task is performed just as it always has been. Without innovation and progress, however, traditional economies result in a lower standard of living when compared to other economic systems.



*Inuit Hunter with his Dog Team*

Although examples of traditional economies exist in Africa, Asia and Latin America, northern Canada, Alaska and Greenland are home to the **Inuit** people. They have survived the harsh, Arctic climate for centuries by teaching their children how to hunt, fish and make tools. These lessons, along with the custom of sharing with the entire village, are passed from one generation to the next. Economists and anthropologists, however, tell us that most traditional economies eventually evolve into other systems. This usually occurs through innovation and technology, but, in the case of the Inuit, it is climate change that appears to have the greatest impact, as the video listed below explains.



Inuit Tradition and Culture



Go to Questions 3 through 6.

## Command Economies

In some societies, the government makes most of the decisions related to the economy. In this situation, people have very little input into what, how or for whom goods and services are produced. This is referred to as a **command, or centrally planned, economy**. Some of the most famous include the former **Soviet Union** and the once-communist bloc countries of **Eastern Europe**. State Planning Commissions determined needs, established goals and assigned production quotas for all industries and farms. The government owned the land and capital required for production. Planners also controlled the workforce. They could easily shift labor and resources from the manufacture of consumer goods to the creation of military equipment on short notice. The Commission also had the power to set prices and wages. Today, there are very few economies that operate primarily on this type of system. In fact, there is no such thing as a pure command economy. However, North Korea and Cuba lean heavily in this direction.

Although a command system does not provide the economic freedom that most people prefer, it does have certain advantages. Because a central authority has the power to address economic issues, leaders can quickly manipulate the factors of production. For example, the Soviet Union transferred its focus from agricultural production to heavy industry in just a few decades. Farms were no longer privately owned and were combined into large collectives controlled by the state. Because the Central Planning Commission believed that this would increase efficiency, some workers could be reassigned. By shifting workers, land and capital on a massive scale, the country allocated its resources to achieve its goal of becoming an international super power. Soviet leaders expected each citizen, male and female, to contribute by working in industry, government service or agriculture. In return, he or she received wages set by the state and public services, such as education and healthcare, at little or no cost.



*Soviet Military Display: May, 1945*

As with any decision, the choice to operate as a command economy comes with opportunity cost. By design, the system places little or no emphasis on consumer goods. During the Cold War, Soviet citizens found that household appliances, cars and adequate housing were in short supply because the nation directed its resources to strengthen its armed forces. Today, North Koreans face similar shortages as their leaders apply most of the country's land and capital to the production of military equipment. Since the government owns the factors of production, laborers have little incentive to work hard. Most factory jobs pay the same, even if they require special skills or come with added responsibilities. There are few rewards for extra effort or suggestions for improvements. Workers are seldom fired for poor performance and, with little to lose, produce low-quality goods. People generally do the jobs that they are assigned and give little thought to those that they might actually like to do. Command economies do not have the flexibility to deal with minor, day-by-day issues since even small changes must be approved by the central authority. They also require a large number of lower-level government officials to enforce quotas and regulations. Although countries continue to experiment with command economies, most have been unsuccessful and have moved to mixed economic systems instead.



Go to Questions 7 through 10.

## Market Economies

An economist defines a **market** as any arrangement that brings buyers and sellers together to exchange goods or services. Markets can be local, regional, national, global and digital. They come in all shapes, sizes and formats. An outdoor farmer's market, a public auction, a restaurant, a grocery store, and an art gallery are all defined as markets by economists. When a society bases its economy on voluntary buying and selling, it operates as a **market, or free market, system** and is based on a set of economic principles called **capitalism**. In a market economy, individuals and businesses decide what, how and for whom to produce goods and services. The consumer plays a key role in this system because producers create goods and services in response to what they are willing to buy. Some of the most productive and wealthiest countries in the world operate on a version of the free market system. The United States, South Korea and Germany are examples.



*Headquarters of Auto Manufacturer BMW: Munich, Germany*

Unlike the command economy, the free market system permits buyers and sellers to function with a high degree of freedom. Producers offer whatever goods and services that they believe will sell, and buyers are free to spend their money as they choose. Opposed to traditional economies in which people are likely to do the same work as their parents, workers in free market economies can leave one job to take another. They can also invest in more education and can train for new careers. Because they thrive on competition and consumer participation, market economies function with little government intervention. Like command economies, however, totally free market economies do not exist. Governments do step in to address certain concerns, such as environmental protection, fair competition and safety. An additional benefit of the market economy is its ability to provide a wide variety of goods and services. It also results in a high level of consumer satisfaction. Almost everyone can satisfy his or her wants since meeting the desires of one group does not necessarily mean that another group will have to sacrifice. For example, if 40% of the people want cars and 60% want pickup trucks, both vehicles are likely to be readily available in a market economy.



## Free Market vs. Command Economies

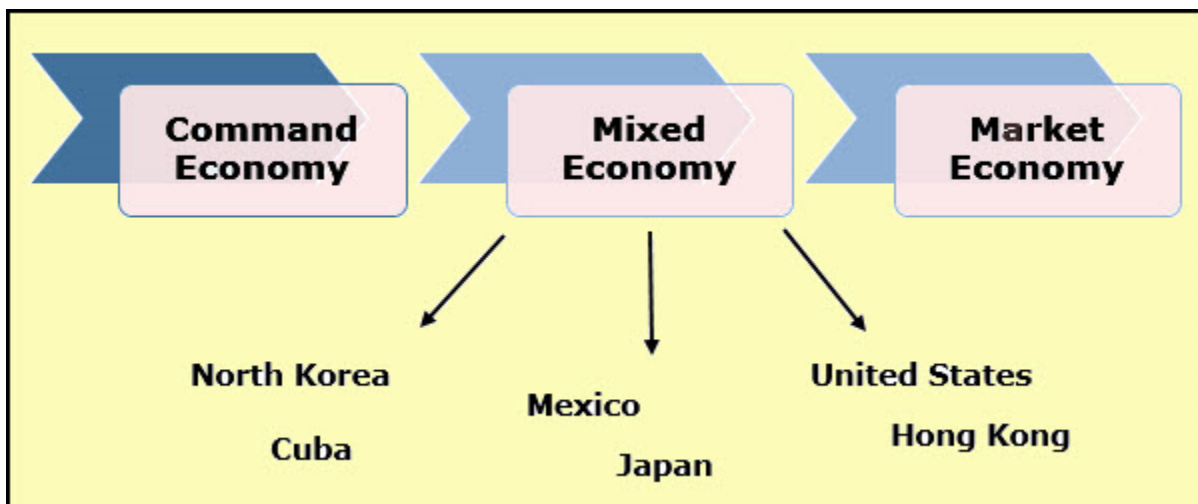
Nonetheless, the consequences of relying on a market economy are not all positive. Because change is likely to occur at any time, workers and business owners live with a high level of uncertainty. Markets gradually adjust to these shifts on their own, but they cause great anxiety in the short term. Companies sometimes move to other locations to lower production costs. Workers must then choose between uprooting their families or new employment. Employers are always threatened by the possibility that another company will manufacture the same goods at a lower cost. Because businesses constantly challenge each other, companies that cannot maintain competitive prices lose customers and, in turn, money. Since buying and selling drive the economy, some citizens, who are too old or ill to care for themselves, cannot survive without assistance from government or private groups. Because businesses concentrate on offering products that they can sell, the market system does on its own produce public services, such as national defense or universal healthcare. Therefore, governments must cover these costs by collecting taxes. The balance between government intervention and free exchange varies from country to country depending on national values and goals.



Go to Questions 11 through 27.

## Mixed Economies

All economic systems have negative consequences. Traditional economies have limited potential for change or growth. Command economies sacrifice consumer needs and restrict freedom. Without laws to ensure fair competition, a few entrepreneurs could easily dominate particular industries within free market economies. Because no single economic system is perfect, countries in today's world rely on a blend of traditional, command and market features to meet their goals. This results in **mixed economies** that are mostly controlled by central planners at one end of the scale and by privately owned businesses on the opposite side of the spectrum.



**North Korea**, for example, has established an economy that is almost totally controlled by its central government. In terms of the factors of production, the government owns all of the land and capital. It also controls the labor. Therefore, industries owned by state produce 95% of the goods and services available to North Koreans. At the same time, the leadership bans almost all imports from foreign countries. Although **China's** economy is also directed by its government,



private citizens own 25% of its industries. In recent decades, the Chinese have relied less on central planning and more on a free market system. To make this happen, the government **privatized**, or sold, some industries and permitted producers to compete in the marketplace. Although these transitions result in positive change in the long run, they are usually difficult and painful in the short term.



At the other end of the scale, some economies operate with very little government intervention. **Hong Kong**, a former colony of Great Britain, currently functions as a special administrative region of China. Here, the private sector drives the economy. There are no barriers to foreign trade, and banks conduct business independently of the government. Although it protects private property, Hong Kong's leadership rarely interferes in the free market. However, there are some exceptions. The government does offer some public services and has established a few limits on prices.



Figure 1 Bank of China Tower: Hong Kong



Go to Questions 28 and 29.

## Free Enterprise

Although not to the same extent as Hong Kong, the United States falls on the market side of the spectrum. It relies on free enterprise, a market system with some government intervention and regulation. Exactly how much government interference Americans are willing to tolerate has always been a subject for political debate. The United States is a geographically and socially diverse country but people do share several, broad economic goals. Primarily, American citizens place a high priority on the **freedom to make their own economic decisions**.

Businesses and individuals want to spend their own money as they see fit. They also expect the nation's economic policies to reflect the traditional values of **justice and fairness**. For example, Americans sacrifice some of their economic liberty by accepting laws that forbid employers to discriminate based on race, religion, age or gender. People also want their economic system to provide as

**many jobs as possible.** This encourages economic growth and increases tax revenue for government services. Americans expect their government to provide a certain amount of **protection from changing economic conditions** or catastrophic events. For this reason, Congress established Social Security to extend disability and retirement benefits that cover most working people. Over 90% of American workers participate in the Social Security system.



*Officials from Canada, Mexico and the United States Signing NAFTA: 1992*

Sharing common goals does not guarantee agreement on how they are to be achieved. Decisions on economic policy are further complicated because the goals themselves sometimes contradict each other. This is a direct result of opportunity cost. For example, trade agreements and tariffs may benefit some industries but cause hardships for others. A law that keeps foreign steel out of the United States could help to meet the goal of full employment but limit individual freedom by resulting in fewer choices for consumers. Debates over the minimum wage, universal healthcare, environmental protection and other issues involve the emphasis of some goals over others. For the most part, citizens, companies and the government are able to resolve these conflicts by making trade-offs. The free enterprise system is flexible and is able to satisfy most Americans most of the time.



Go to Questions 30 through 32.

## **What's next?**

In this unit, you have read about different types of economies and the factors that influence their decisions concerning what, how and for whom to produce. Because the United States operates as a market system, exchanges between buyers and sellers not only determine the cost of most goods but also the amount of goods that businesses produce. In the following unit, you will examine the demand side of the marketplace and the economic principles that govern its impact.