Economic Systems
What is an Economic System?

• **Economic system**: how society uses resources to satisfy people’s wants
  • Seeks to answer the three economic questions:
    • **What to produce?**
    • **How to produce it?**
    • **For whom to produce?**
  • Remember, due to scarcity we **cannot** produce everything we want
TYPES OF ECONOMIC SYSTEMS
Traditional Economy

- The oldest economic system
- Existed since the emergence of hunter-gatherer societies
- Traditional economies engage in farming, herding, fishing, hunting, and the gathering of wild plants
- Tasks are determined by social customs
Command Economy
(Centrally Planned Economy)

- Capitalism gave rise to socialism and communism
- It was believed workers were being exploited by business owners as work hours were long and wages were low
- In 1848, economist Karl Marx and philosopher Friedrich Engels published The Communist Manifesto
  - This book advocated the overthrow of capitalism
Command Economy
(Centrally Planned Economy)

- They favored socialism--a political and economic philosophy--that calls for property to be owned by society as a whole, rather than by individuals, for the equal benefit of all
- Marx and Engels called on workers everywhere to revolt against their governments
They believed that once the workers had gained power, private property and the free market would be replaced with national ownership of industry and a more equal distribution of income.

They believed communism could be achieved, a political and economic system in which all property and wealth is owned by all members of society.
Command Economy
(Centrally Planned Economy)

- In a communist society classes disappear
- In 1917, the Russian Revolution took place and resulted in the creation of a much more authoritarian state than Marx and Engels had envisioned
Command Economy
(Centrally Planned Economy)

- The result was a government that made all economic decisions and engaged in central (economic) planning
  - These planning agencies decided what goods and services should be produced
  - Decided which farms and factories should get which resources to produce what was planned
  - They also controlled prices and wages and decided how goods and services should be distributed
Command Economy  
(Centrally Planned Economy)

- This led to shortages of goods
- Wages were determined by the government, not by skill or ability, which also caused problems
There are no pure command economies today.

However, some economies, like North Korea, still have mostly command elements.
Market Economies

- Market economies developed from the Industrial Revolution
- New inventions and manufacturing processes spurred the growth of industry
- Individual investors, called capitalists, grew wealthy by accumulating capital, such as machinery, factories, railroads, etc.
• The term capitalism came to be synonymous with the free market economic system

• A market economy is driven by choices of consumers and producers
  • Consumers spend money, can go into business, and sell their labor as they wish
  • Producers decide how to use their resources to make the most money
Fundamentals of a Market Economy

1: Private Property and Markets

• **Private property rights**: the rights of individuals and groups to own property
  • Examples: clothes, furniture, house, car, etc.
• For a market economy to work, private property rights need to be clearly defined and enforced
Fundamentals of a Market Economy

2: Limited Government Involvement

- **Laissez faire**: government should not interfere in the economy
- **Capitalism**: system having private ownership of factors of production
  - Producers will create products and consumers create demand
- Actual market economies all have some government involvement
Fundamentals of a Market Economy

3: Voluntary Exchange in Markets

• **Voluntary exchange**: the buyer and seller both believe that the benefits of the trade outweigh the costs

• Sellers are motivated by profit
4: Competition and Consumer Sovereignty

- **Consumer sovereignty**: buyers choose products and control what is produced

- **Competition** controls self-interested behavior
  - Sellers offer low price or high value to please consumers and to make a profit
Fundamentals of a Market Economy

5: Specialization and Markets

- **Specialization**: people concentrate their efforts in the activities they do best
  - Encourages efficient use of resources
  - Leads to higher-quality, lower-priced products
Circular Flow in Market Economies

• The **circular flow model** illustrates how interactions occur in a market
  • Represents the two key decision makers: households and businesses
  • Shows the two markets where households and businesses meet
    • Goods and services
    • Resources
Circular Flow in Market Economies

- **Product Markets**
  - **Product market**: market where goods and services are bought and sold
    - Includes all purchases by individuals from businesses

- **Factor Markets**
  - **Factor market**: market for the factors of production: land, labor, capital, and entrepreneurship
Circular Flow in Market Economies

- The circular flow model shows how market economies operate
  - Outside arrow shows flow of money
  - Inside arrow shows flow of resources and products
Circular Flow Model

- Product Market:
  - Business revenue
  - Consumer spending
  - Sell goods and services
  - Buy goods and services

- Factor Market:
  - Businesses (Sell productive resources)
  - Households (Buy land, labor, capital, entrepreneurship)
  - Payments for resources
  - Income from resources
Mixed Economy

• In a mixed economy, the government and individuals play important roles with regard to production and consumption
• Who decides what varies from one country to another
• Every nation with a mixed economy develops its own balance between market freedom and government involvement
Mixed Economy

- The government enables markets to operate
  - Legal systems exist
  - Laws are enforced
  - A stable currency exists

- The government may also provide certain public works projects (highways, sewer systems, etc.)

- Some governments may also provide free college education