**Economic Systems**

**LVL I Answer the following questions as you read**:

1. What main factor do economists consider when classifying economic systems?
2. What are the three main economic systems?
3. Define the main elements that are used to evaluate economic systems: private ownership, profit motive, consumer sovereignty, competition, and government regulation.
4. What are the characteristics of a traditional economy with regard to the five main elements?
5. What are the characteristics of a command economy with regard to the five main elements?
6. What are the characteristics of a market economy with regard to the five main elements?
7. What are the characteristics of a mixed economy with regard to the five main elements?
8. What are the three basic economic questions of production that nations must answer?
9. What are the social and economic goals that nations try to meet?
10. What is the goal for price stability in a nation?
11. How does the U.S. try to stabilize prices?
12. What is the target rate of inflation in the U.S.?
13. What will happen to consumer purchasing power if prices rise (inflation)?
14. What factors can have an impact on price levels?
15. How does the U.S. define full employment?
16. What is most commonly measured to determine economic growth and sustainability?
17. What is the target rate for real GDP growth?
18. What do economists consider when providing input on how to build a sustainable economy?
19. What are other methods of allocating resources?
20. How does the U.S. try to meet the social economy goal of equity?
21. What is an essential element to have in order for a market economy to exist?
22. **Compare traditional, command, market, and mixed economic systems with regard to private ownership, profit motive, consumer sovereignty, competition, and government regulation.**

**Economic systems** are models economists use to explain how decision-makers in an economy are likely to view certain economic principles. While economists identify **traditional, command, and market** as the three distinct economic systems, real world economies are usually “**mixed**”. That is, real world economies have some characteristics of all three economic systems, but tend to lean toward one of the three. Before we examine how each economic system regards the economic principles in this element, let us define each. **Private ownership** refers to the ability of individuals and businesses in an economy to buy, sell, and hold property as they wish without fear government interference or seizure. The profit motive incentivizes entrepreneurs to take the risk of starting a business. **Profit** is the amount of revenue (price times quantity sold) received by a business minus the costs of operating the business. If the revenue is greater than the cost of operation, the business will make a profit and the entrepreneur will receive the profit. This potential reward for the entrepreneur drives them to start businesses. **Consumer sovereignty** determines the goods and services an economy produces because businesses will only produce those products that consumers are willing to buy. **Competition** refers the characteristics and behavior firms in a particular market or industry. Finally, **government regulation** refers to the extent to which a central authority has control over the production and consumption decisions in an economy.

In a **Traditional Economy** property rights are based on historical property rights and transfer of property would follow traditional rules of the culture. People who provide goods and services most likely provide the same good or service their ancestors provided. It would be difficult for someone to work in a field other than the one his or her ancestors had. The production of goods and services is based on what has always been produced so changes in consumer taste for new goods and services would not change the goods and services produced in the economy. There may be more than one seller of a particular good or service, but the sellers are likely to continue operating the same way their ancestors operated so it is unlikely that competition will lead to lower prices or a more efficient use of resources. Traditional leaders, like councils of elders or tribal chiefs, will typically be in charge of moderating disputes between members of the community. They will make their decisions based on how the culture has decided in the past.

In a **Command Economy** property rights, if any, are insecure since central planners make all economic decisions. Property seizures are common if the central planner thinks the property should be used in another capacity. Little opportunity to pursue individual rewards since all economic decisions are made by a central planner. Small businesses, if allowed, will likely return a large percentage of profits to the central government. Individual consumers have little say in what businesses or government producers offer as goods and services. They may be told how much of each good or service they are allowed to have. Even if consumers have money available to buy, there may be shortages of the more desirable goods because the central planners did not authorize the right level of production. Since the government is the producer of most goods and services, there is little or no competition among individual firms. This means there is little incentive to innovate, lower prices, increase quality, or use resources efficiently. The government or central planner makes almost all decisions about the production of goods and services in the economy.

A **Market Economy** is one where property rights are strong. Individuals and firms own all the factors of production. If a government exists, its main role is to apply the rule of law governing property rights to all property disputes in a fair and equal way. The profit motive incentivizes individuals to start new businesses and to make their businesses efficient. Firm owners will be able to keep most or all of their business profits. Firms produce only the goods and services they think consumers are willing and able to buy. Products that do not sell will be discontinued and firms will increase the quantity supplied of products that are popular with consumers. There is a high level of competition because firms can freely open and close businesses. The entry of new businesses in the market for a product incentivizes firms to lower prices, increase quality, and/or become more efficient with resources. Government

regulation is minimal. If regulation exists, the focus is on protecting property rights, ensuring high levels of competition, and protecting consumers from harm.

In **Mixed Economic Systems, i**ndividuals and firms can own property and the rule of law decides property disputes. Government can also own property to provide public goods and services. Government will sometime seize property and pay the owner fair market value if the property in question is to be used for an essential public good or service. Entrepreneurs can freely start businesses, but will usually be required to pay a certain percentage of their profits in taxes to the government. Businesses will usually produce what consumers want to buy. However, government may recognize that certain public goods and services will not be produced in great enough quantity by the private market and will produce the product as a public good or service. High levels of competition are encouraged, but government may allow certain monopolies to exist if there is a compelling reason to have one producer of the good or service. The government may require licenses and government paperwork to start the business. Businesses may have to follow government labor, consumer safety, and environmental laws.

**b. Analyze how each type of system answers the three economic questions and meets the broad social and economic goals of freedom, security, equity, growth, efficiency, price stability, full employment, and sustainability.**

Each economic system answers the three basic economic questions in a different way. The three main economic questions are what to produce? How to produce? And for whom to produce?

In a Traditional economic system the economy will produce the goods and services it has produced for generations based on what the ancestors produced. The economy will pass the same production methods used in the past from generation to generation. Goods and services are distributed using the methods used by past generations.

Command economies will produce what the government or central planner says it will produce. The economy will produce using whatever methods the government or central planner says it will use. The economy will distribute the goods and services to whomever the government or central planner says should get it.

In a market economy, firms will produce what they believe consumers will want to buy. Firms will produce goods and services using methods they believe will result in selling goods and services for the most profit. Individuals and firms in the society who are willing and able to pay the price of the good or service will obtain it.

Many firms will produce what they believe consumers will want to buy, but government may restrict the production of certain goods or produce public goods in Mixed Economies. Firms will try to produce goods and services using methods they believe will result in selling goods and services for the most profit, but the government may tax firm profits or mandate production processes that minimize harm to the public. Individuals and firms in the society who are willing and able to pay the price of the good or service will usually obtain it, but the government may restrict some people from accessing certain goods or may decide to produce a public good for specific people in the society.

**Social Economic Goals**

The social economic goals are the values underlying the economic system a country chooses and act as a guiding force as individual, businesses, and governments in the economy make economic choice.

**Economic freedom** refers to the ability of consumers, producers, and workers to make their own decisions about consumption, production, and distribution of goods and services. The more individuals and businesses make these decisions, the more economic freedom exists in the economy. Market economies tend to have a great deal of economic freedom while command economies may limit economic freedom in favor of more equal distribution of wealth.

**Economic equity** refers to fairness within the economy. There is a lot of debate in public policy about what is fair. Some people define fairness as equal access to jobs, goods, and services. Others define fairness based on outcomes. For example, if someone works hard to start a successful business, many believe that it is “fair” for that individual to keep the profit from that business. Market economies pursue this goal by ensuring competitive markets and protecting property rights. Command economies pursue this goal by redistributing wealth and ensuring everyone’s access to public goods.

**Economic security** has to do with protecting individuals and businesses from risk. In a market economy, individual workers and business owners are usually responsible for themselves during challenging economic circumstances. They protect themselves through insurance available in the private market or by saving money for the future. In command economies, the government provides security through government insurance programs, guaranteed jobs, and housing/food allowances.

**Economic growth** is increasing production of goods and services over time. This occurs through increases in factors of production or new technological innovations. Most countries measure growth through calculating the percentage change in real GDP from one period to the next. Real GDP is the total value of all final goods and services produced within a nation in a given time period adjusted for inflation. Although both command and market economies are capable of growth, command economies are capable of growing rapidly, using within targeted sectors, when guided by a central planner. Market economies may grow more slowly, but growth tends to be more sustainable through the organic forces of supply and demand within markets instead of arbitrary targets.

**Economic efficiency** when factors of production are allocated to their most productive use. The most efficient economies have fully employed resources, specialize in goods and services for which they have the lowest opportunity cost, and have high levels of competition in the market. Market economies tend to be very efficient due to competition and free trade. Supply and demand allows price to ration factors of production, goods, and services and allocate them to the most efficient uses. Command economies may be less efficient since there is no competition if government owns all the productive resources, everyone has to have a job, and no profit motive drives the people to reduce the costs of production.

**Price stability** refers to an economy making sure that increases in the overall price level of goods and services in the economy is predictable and protects the purchasing power of money in the economy over time. In the U.S. economy, the Federal Reserve system uses monetary policy, tools to increase or decrease the quantity of money in circulation, to target a predictable inflation rate of 2%. In market economies, price levels can fluctuate with increases and decreases in the business cycle, rising significantly in expansionary times and falling drastically in times of financial crisis. Command economies are more likely to have central authorities who take action against rising or falling price levels through fiscal or monetary policy.

The goal of **full employment** seeks to ensure that all those who are willing and able to work have the opportunity to do so. In the U.S., full employment is typically an unemployment rate between 4% and 6% depending on economic conditions. The unemployment rate is never zero because of people moving from one job to another or people graduating from an educational program and looking for a job. Market economies can achieve full employment during strong expansions, but will often suffer high levels of unemployment during contractions. Command economies will try to ensure full employment, but will often employ resources in less efficient uses and pay income much lower than that found in a market economy.

**Economic sustainability** usually refers to the goal of individual countries to maintain an upward trend of real

Gross Domestic Product growth in the long-run. For highly developed countries, the goal for long-run real GDP growth trend desired may be 2-3% while it may be much higher for developing countries. To achieve these targets, countries must make decisions and create conditions benefitting the economy for the long term as well as the short term. There are many viewpoints about sustainability, but some of the considerations in building a sustainable economy could include food systems, environmental protection, new business creation, technological development, and the health of the overall financial system. In market economies, sustainability is a goal if firms believe it is in the firm’s self-interest to pursue sustainability. In command economies, the government or central planner will determine the type of sustainability to pursue.

**c. Compare and contrast strategies for allocating scarce resources, such as by price, majority rule, contests, force, sharing, lottery, authority, first-come-first-served, and personal characteristics.**

The third basic economic question all societies must answer is for whom to produce. **Allocation strategies** are the methods available to societies as they seek to answer this question. First, it is important to describe each of the strategies and then compare the benefits and costs of using one over another.

* **Price:** This refers to allowing the forces of supply and demand to determine a market price. Supply is the amount of a good, service, or factor of production a seller is willing and able to sell at each price. Demand is the amount of a good, service, or factor of production that a buyer is willing and able to purchase at each price. The price at which the quantity demanded by the buyer is equal to the quantity supplied by the seller is the market price. This allocation strategy allows rationing of a resource based on who can afford the price set by the market. The more desirable and relatively scarce the item, generally, the higher the price. This method is efficient because one can easily tell whether he or she can obtain the good, service, or factor of production based on his or her willingness and ability to pay the price. However, this method will exclude people from markets if they lack the money to pay the price.

**United States Example:** If one would like to obtain a banana, one must pay the price per pound indicated by the grocery store. If one has no money, one gets no banana.

* **Authority:** This strategy is based on the decisions of a person in power or group of people who make most of the decisions about who gets to obtain a good, service, or factor of production. This allocation strategy allows for quick action because a person or a group of people in power can make and implement the decisions quickly.

**United States Example:** Elected representatives have the authority to pass legislation requiring workers to pay a tax on the income they earn.

* **Force:** When allocating by force, goods, services, and factors of production are given or taken away under using threats. In countries where the government makes and carries out decisions by force, economic changes can happen quickly because the government decides how to distribute all items and enforces the decision through military/police power.

**United States Example:** In the United States, most people are free to choose the work they would like to do. However, when the United States had a military draft during the Vietnam War, the United States arrested those who did not report for military duty.

* **Lottery:** This allocation strategy, also known as random selection, gives everyone who wants the good, service, or factor of production equal odds of obtaining it. This strategy can be inefficient because it may allocate the resource to a purpose or person who does not need it or who will not put it to a productive use. If the government randomly selects individuals to receive farmland, the land may go to someone who has no knowledge of farming techniques and the land resource may be underutilized.

**United States Example:** In the case of conscripted military service, force was not the only allocation strategy employed. The photograph below shows the lottery held in 1940 to select the first group of Selective Service registrants for the newly initiated draft. Secretary of War, Henry Stimson, chose the first number from the bowl and it was 158. Nationally, 6,175 men held the number 158. All of them had to report to their local draft board for assessment of their military service fitness.

* **First Come, First Served:** This allocation strategy allows people to receive a good, service, or factor of production if they get to it first or are one of the people close enough to the front of the line to receive the good, service, or factor of production before there are none remaining. This can be an inefficient strategy since the time spent waiting in a physical or virtual line took time away from more productive activities.

**United States Example:** At one time, a teenager who wanted to take the driver’s license road test had to arrive early and get in line for the opportunity to take the test. The aspiring driver might wait in line all day for the test. Now, the Georgia Department of Driver’s Services allows potential drivers to schedule a road test for a specific date and time, eliminating the first come, first served strategy and improving efficiency.

* **Majority Rule:** This strategy occurs when a group of people who have control over a good, service, or factor of production vote to decide how it will be distributed. In the best case, the vote will have a significant majority in favor of the decision and the decision will be in society’s best interest. However, if the majority has a small margin, many people may be unhappy with the decision. If the majority is corrupt or makes the decision based on favoritism or fear, the good, service, or factor of production allocation may not be efficient.

**United States Example:** National, state, and local governments sometimes vote to establish public parks and greenspace. In some cases, there are citizens who would rather the land be used for commercial production. When the majority of elected representatives vote for the public land use, those who favor private ownership of the land are unable to access the factor of production.

* **Personal Characteristic:** This allocation strategy allows resources to be distributed based on need or merit. Ideally, the person who gets the good, service, or factor of production is the one who will put it to the best use. However, personal characteristics can be barriers to keep certain individuals from receiving the allocation.

**United States Example:** Many college scholarships are given out based on either the needs of the students are their merit for the award.

• **Contest**: This allocation strategy can distribute the resource to the person who wins. The “winning” could be based on running a race (who is fastest), in academics (valedictorian has the highest GPA), or in a test of knowledge/skill (Jeopardy contestant or chess champion). This strategy can be inefficient on a day to day basis. You don’t want to run a race to see who gets the last slice of pizza in the cafeteria. It would take too long.

**LVL II Consider the following questions**

1. Why does a market or mixed economy do a better job of promoting economic freedom, growth, efficiency, and sustainability than a command economy?
2. How are most real world economies viewed today?
3. How does price allocate resources throughout the economy?

**LVL III Do the following**

1. Provide a real world example of how you encountered one of the nine allocation strategies.