5. Economic Systems Around the World

Just as forms of government vary from one nation to the next, so do **economic systems**. An economic system is a way of organizing the production and consumption of goods and services. Economic systems exist because people must meet certain needs to survive. These survival needs include food, clothing, and shelter. In addition, people have endless wants. Such wants may include things that make life more comfortable, more entertaining, or more satisfying in some way.

Three Fundamental Economic Questions: What to Produce, How, and for Whom?

If a nation's resources were unlimited, it might be possible to meet all of these wants and needs. But such is never the case. Resources are always limited. As a result, every economic system must answer three fundamental economic questions:

What goods and services should be produced? For example, should a nation's limited resources be used mainly to provide public goods, such as clean air and water, or to produce private goods, such as homes?

How should these goods and services be produced? Should corn and wheat be raised mainly on giant factory farms? Or is farming better done on smaller family farms?

How should the people share goods and services? Who should get what? Only those who can afford whatever they want? Or should goods and services go to the people who need them the most?

Economic systems differ from one country to another because each society answers these questions in its own way.

The Four Factors of Production: Land, Labor, Capital, and Entrepreneurship

Countries also differ in how they use what economists call the **factors of production**. These factors are the resources required to produce most goods and services. They include the following:

Land. By land, economists mean the natural resources of a nation. These raw materials include fertile soil, water, plants, and minerals.

Labor. Labor refers to the effort—both mental and physical—that people put into producing goods and services.

Capital. The term *capital* has multiple meanings. It can mean the money needed to start a business. It can mean the machinery, buildings, tools, and equipment used to produce goods and services. It can also mean human capital—the knowledge and skills that workers bring to their jobs.

Entrepreneurship. This last factor is the human effort that goes into organizing land, labor, and capital to produce and sell goods and services. Entrepreneurs risk their money and time to turn an idea into something that people will want or need.

The way a society uses these factors of production is determined by its economic system. Three basic types of economic systems exist in the world today: traditional, market, and command.

Traditional Economies: Decision Making by Custom

In a society with a traditional economy, people rely on time-tested customs to answer the three fundamental economic questions. What worked for their ancestors still works today.

People in traditional economies provide for themselves. Some are hunters and gatherers, as they have been for thousands of years. The majority are farmers. Most people in a traditional economy live at a subsistence level, producing just enough goods to feed, clothe, and house their families. If they have any goods left over, they trade them for other things they need or want.

Many of the Inuit of Alaska and northern Canada still maintain a traditional economy based on hunting and fishing. They rely on skills and strategies that have helped their people survive since prehistoric times. Likewise, many African farmers and herders follow the same economic patterns as their ancestors.

In a traditional society, the production and distribution of food, clothing, and shelter is woven into the fabric of society. Economic activities do not need to be coordinated or regulated in any way by the government. Tradition and community values serve to keep the economy running smoothly. However, the standard of living of most people in traditional economies is very low. Families do not earn enough to do more than meet their most basic needs. They have only limited access to goods such as cars or services like medical care.

Market Economies: Decision Making by Individuals

In a country with a market economy, individual producers and consumers answer the three basic economic questions. In a pure free-market economy, the government plays little or no role in economic affairs. Producers are free to decide what goods and services to produce and how much to charge for them. Consumers are free to decide what to buy. Prices are determined by the **market**. In economic terms, a market is any place or situation in which people buy and sell goods and services.

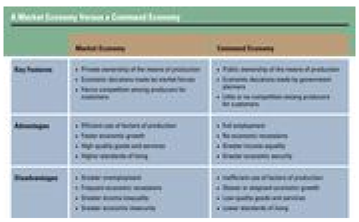
You have probably heard other names for a market economy. Some people refer to it as a **free enterprise system**. A free enterprise system relies on the profit motive, economic competition, and the forces of supply and demand to direct the production and distribution of goods and services.

Others use the term **capitalism** to describe a market system. Under capitalism, individual investors, or capitalists, privately own the means of production, such as farmland or factories. Workers provide labor in exchange for wages or a salary.

One advantage of a market system is its efficiency at meeting peoples' needs. When demand for a product rises, its price in the market goes up. This signals businesses to produce more. Meanwhile, competition among producers of similar goods usually keeps prices from rising too high. Efficiency also leads to economic growth. Businesses invest in factories and equipment, as well as in research and technology, to stay competitive. This helps the economy grow.

One disadvantage of a market economy, some would argue, is its instability. Periods of growth and prosperity in market economies usually alternate with recessions, or slow-downs, in business and employment. During these downturns, people who lose their jobs suffer from a loss of income.

Another disadvantage of a market economy is its unequal distribution of wealth. The market divides wealth to people according to how society values what they do. For example, a quarterback whose team wins the Superbowl earns more than a public school teacher. This may seem unfair, but there are more teachers than Superbowl-winning quarterbacks.



Command Economies: Decision Making by Government Planners

In a **command economy**, the government answers the three basic economic questions. In a pure command economy, the means of production are publicly owned. Government planners decide what goods and services should be produced and how. They also determine how goods and services should be distributed to consumers and at what cost.

Command economies are based on political theories that arose in Europe during the late 1800s. Known both as **socialism** and communism, these theories addressed the inequalities of capitalism by calling for public ownership of farms and factories. Once the people controlled the means of production, the economy could be operated on such principles as equality and fairness to all. Karl Marx, the originator of communism, summed up how such an economy would work in this slogan: “From each according to his ability, to each according to his needs.”

In theory, a command economy has distinct advantages over a market economy. Central planners can ensure full employment by devising enough projects to absorb all members of the workforce. This ability, along with controls on prices, can bring stability to the economy. A command economy can also distribute income more equally than a market economy, because everyone shares in the nation's wealth.

In practice, however, the performance of command economies has been disappointing. Because the government controls wages and prices, workers have little incentive to work hard or to produce high-quality goods. The goods they do produce are usually inferior to similar goods produced in a market economy.

The core problem in a command economy is that government planners, no matter how well intentioned, are less efficient at making economic decisions than the market is. By harnessing the intelligence of millions of buyers and sellers, the market is far better at providing people with what they want and need than government officials will ever be.

Mixed Economies: Shared Decision Making

Pure forms of traditional, market, and command economic systems do not exist today. They are theoretical extremes. In the real world, most countries have **mixed economies** that fall somewhere in between those extremes. A mixed economy blends reliance on market forces with some government involvement in the marketplace. The degree of that involvement varies from country to country.

The United States has historically had a free-market economy. Yet the government plays a vital role in economic affairs. The government, for example, protects private property rights. It regulates the marketplace to protect both consumers and producers from unfair business practices. It also redistributes wealth to those in need through its social welfare policies.

In contrast, China has had a command economy since the Communist Party took control of its government in 1949. For many years, the communist government controlled every aspect of the Chinese economy. The result was economic stagnation.

In the late 1970s, the Chinese government moved from a strict command economy to a system called market socialism. This system mixes public and private ownership of businesses. It also encourages competition in the marketplace. At the same time, the Communist Party has remained in overall control of the economy. As Deng Xiaoping, the leader of this change, explained, "Planning and market forces are both ways of controlling economic activity."