

# Who Decides What in Different Economic Systems?

In the process of answering the three economic questions, every society develops an economic system. An **economic system** is the way a society coordinates the production and consumption of goods and services. Economic systems are as old as humankind, so you might expect there to be many different models. But if we strip away all the cultural differences that exist between all the societies that ever were, we find that history has produced only three basic types of economic systems. There are those built on tradition, those based on the command of rulers, and those organized by free markets. Each system answers the three economic questions differently. And each emphasizes different economic goals.

## Traditional Economies: Decision Making by Custom

The first and oldest economic system is the traditional economy. Traditional economies have existed since the first clans of hunter-gatherers emerged in Africa. In a **traditional economy**, custom and tradition dictate what to produce, how to produce it, and for whom.

Most traditional economies that survive today belong to indigenous people who live much as their ancestors did hundreds or thousands of years ago. The Maasai of East Africa, for example, are a seminomadic herding people. Livestock, primarily cattle, is the mainstay of their economy and Maasai wealth is measured in cattle and children. The traditional Maasai diet consists primarily of meat, blood, and milk from cattle. The Maasai's answer to the question of *what to produce* is cattle, because it is their centuries-old tradition to raise cattle.

As for the question of *how to produce*, people in traditional economies engage in farming, herding, fishing, hunting, and the gathering of wild plants. Exactly who does what is determined by social customs. Labor is often divided along gender lines. Among the Maasai, for example, men build enclosures to protect the cattle from lions, boys graze the cattle, and women and girls milk the cattle. Among the Khoi-San people of the Kalahari Desert in Southern Africa, men hunt and women gather.

*For whom to produce* is another question decided by tradition. Social hierarchies play an important role. A good illustration of this is the way meat is distributed among the Khoi-San people of the Kalahari. After a hunt, the kill is divided up, with a large share going to the hunter. He gives some to relatives, and they give part of theirs to other relatives, all according to the accepted social order. In the end, everyone gets enough to eat.

The highest goals of people in a traditional economy are economic stability and security. Most want nothing more than to live as they always have, following traditional ways of life, in harmony with nature. For most traditional societies, though, this goal is increasingly difficult to attain. Traditional economies have become shrinking outposts of the past surrounded by the modern world. As modern economies exert an ever-growing influence, traditional societies are struggling to find a path to economic survival.



### **Command Economies: Decision Making by Powerful Rulers**

The next economic system to develop is what economists call a command economy. In a [command economy](#), decisions about what, how, and for whom to produce are made by a powerful ruler or some other authority.

The earliest command economies originated in Mesopotamia, Egypt, China, and India about 5,000 years ago. As these civilizations became highly advanced, centralized governments arose that were headed by powerful rulers. These rulers imposed their economic choices on society. This happened even as tradition still guided economic activity at the lower levels of society.

Rulers at the top of these early civilizations—kings, pharaohs, emperors—commanded the populace to devote economic resources to building projects or military adventures. Many thousands of people might be conscripted to build a pyramid, defensive wall, irrigation canal, temple, or road. In a preindustrial age, such projects took vast quantities of human labor. Often, many people would be drafted into a ruler's army and sent into battle in distant lands.

The primary goal of these ancient command economies was to accumulate wealth and goods for the ruling class while preserving economic stability. The many monuments these societies left behind are a testament to both the productive power of these economies and the excesses of their rulers.



### **Market Economies: Decision Making by Individuals**

The newest economic system to emerge in human history is the market economy. A [market economy](#) depends not on tradition or command to coordinate its activities but on the decisions of individual producers and consumers. Note that when economists speak of “the market,” they are referring to the economic system within which buyers and sellers exchange goods and services. This is distinct from an everyday market, which is a place where people buy and sell goods.

In a [free market economy](#), the workings of the market are not planned or directed. No one—no single person, business, or government agency—tells producers or consumers what to do. Economic decisions are made voluntarily, one at a time, by millions of individuals guided by self-interest.

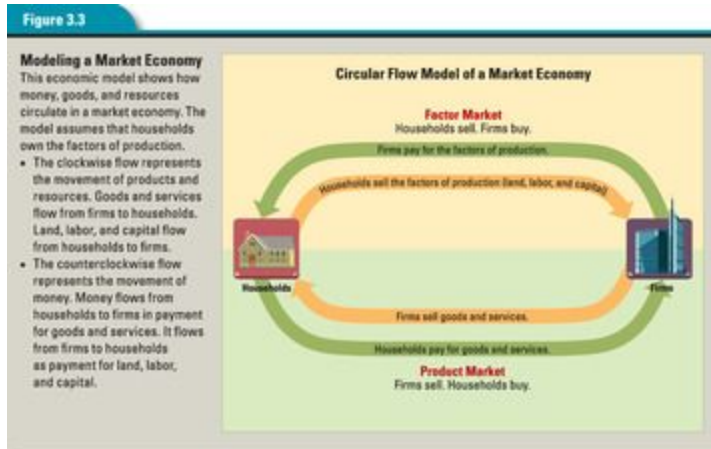
The highest goals of a market economy are economic freedom and efficiency. Individuals and businesses are left at liberty to decide what, how, and for whom to produce. The producers of goods and services make these decisions based largely on consumers' spending decisions. Because you are free to buy what you want, producers must compete for your dollars. This competition means that you, the consumer, have many choices. It also forces producers to use resources efficiently. If they do not, a competitor will find a way to offer the same good or service at a price that consumers will be more willing to pay.

In a free market, individuals are encouraged to pursue the jobs that allow them to make the most of their human capital. If one employer fails to pay them what they think they are worth, they can quit and seek employment elsewhere. Or they can start their own businesses, perhaps even offering new products or services to consumers.

You might expect that the result of all this individual decision making and competition would be chaos. But as the markets-coordinate-trade principle reminds us, just the opposite is true. Markets are highly efficient at producing a great variety of goods and services that people find attractive and at prices they are willing to pay. It was this coordinating power of markets that Adam Smith famously described as “the invisible hand.” He wrote,

*Every individual . . . neither intends to promote the public interest, nor knows how much he is promoting it . . . He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.*

—Adam Smith, *The Wealth of Nations*, 1776



### The Flow of Money and Goods in a Market Economy

The reason markets work so well is that one person's output always becomes another person's input. Goods are produced and consumed. Money comes in and goes out. This flow keeps the economy running. Economists use the [circular flow model](#), like that in Figure 3.3, to illustrate these interactions.

In the simplified market economy shown in the model, there are two kinds of participants: households and firms. A [household](#) is made up of a person or of a group of people living together. The model assumes that households own the factors of production. A [firm](#) is an organization that uses these factors to make and sell goods or services.

The model also shows two kinds of markets. One is the [product market](#), in which goods and services are sold by firms and purchased by households. Your local mall or supermarket is part of the product market. The other is the [factor market](#), in which households sell their land, labor, and capital to firms. A household, for example, might rent land to a firm. Or members of a household might sell their labor to a firm for wages. They might loan money to a firm in exchange for interest payments, or they might buy a firm's stock in the hopes of receiving dividend payments. The funds paid to households—whether in the form of rent, wages, interest, or dividends—are known as [factor payments](#).

Follow the arrows of the diagram to see the circularity. Households buy products from firms with money that they receive in the factor market. Firms acquire land, labor, and capital from households using money that they receive in the product market. For example, you (as part of a household) might buy a pair of jeans from a firm with money that you earned by working at a local ice cream parlor (another firm). The ice cream parlor, in turn, pays you for your labor with money that it receives from selling ice cream cones to other households.

All these transactions are conducted by people and businesses who want something for themselves. People work so they can buy things. Firms employ people so they can make things to sell. In a market economy, everybody chooses what is best for him or herself. As Adam Smith wisely observed, “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.”

### Capitalism Gives Rise to Socialism and Communism

Market economies emerged in Europe in the 1700s and began to grow rapidly in the 1800s. This economic growth was a direct result of the [Industrial Revolution](#). During the Industrial Revolution, new inventions and manufacturing processes

spurred the growth of industry. Individual investors, called **capitalists**, grew wealthy by accumulating capital, including machinery, factories, railroads, and the like. The term **capitalism** came to be synonymous with the free market economic system.

The headlong growth of capitalism had profound effects on society. As more and better goods became widely available, people's standard of living improved. But capitalism did not improve the quality of life for everybody. The workers who filled the factories and mills labored under harsh conditions, often working extremely long hours for meager wages. Critics of capitalism blamed the capitalists for exploiting workers and keeping them in poverty.

In 1848, economist Karl Marx and philosopher Friedrich Engels published *The Communist Manifesto*, in which they advocated the overthrow of capitalism. They proposed an alternative vision of society known as socialism. **Socialism** is 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.

To bring about this socialist vision of society, Marx and Engels called on workers everywhere to revolt against their governments. Once the workers had gained power, private property and the free market would be replaced with national ownership of industry and more equal distribution of income.

The final phase of socialism, in the view of Marx and Engels, is **communism**, a political and economic system in which all property and wealth are owned by all members of society. In a communist society, class differences—and the conflicts they create—disappear. Once that happens, government is no longer needed to keep order. Instead of self-interest, people in a communist society are guided by Marx's famous slogan: "From each according to his ability, to each according to his needs."

### **Modern Command Economies: Decision Making by the State**

The ideas of Marx and Engels spurred the development of political movements dedicated to the creation of a workers' paradise. But when the first successful communist revolution took place in Russia in 1917, it did not lead to the utopian society Marx had envisioned. Instead, the revolutionaries formed an authoritarian government that pursued its socialist goals with brutal force. The renamed Union of Soviet Socialist Republics, or Soviet Union for short, became the first modern command economy.

In the Soviet Union, private ownership of property was forbidden. The state owned the factors of production. **Economic planning** was done by government committees of economists, production experts, and political officials. These central planning committees attempted to perform the functions of a market. They decided what goods and services should be produced. They decided which farms and factories should get which resources to produce what was planned. Committees also controlled prices and wages and decided how goods and services should be distributed.

In theory, this kind of planning was supposed to ensure economic equity and security—two important goals of a modern command economy—but the reality was very different. The planning committees could not keep track of the millions of products and prices in the Soviet system. Two Soviet economists described what happened when Goskomstén, the committee in charge of prices, raised the price that the government would pay hunters for moleskins.

*State purchases increased, and now all the distribution centers are filled with these pelts. Industry is unable to use them all, and they often rot in warehouses before they can be processed. The Ministry of Light Industry has already requested Goskomstén twice to lower purchasing prices, but the "question has not been decided" yet. And this is not surprising. Its members are too busy to decide. They have no time: besides setting prices on these pelts, they have to keep track of another 24 million prices.*

—Nikolai Shmelev and Vladimir Popov, *The Turning Point: Revitalizing the Soviet Economy*, 1990

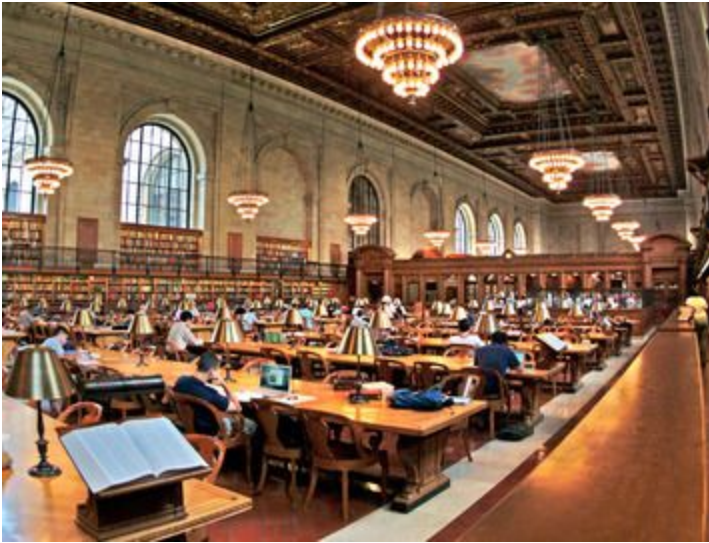
In this planned economy, shortages were common. Long lines would form to buy whatever goods suddenly became available, but once a customer got to the front of that line, choice was limited or nonexistent.

Planners made matters worse by ignoring the incentives-matter principle. The wages paid to workers were determined by government committees, not by a worker's ability or output. A poor worker could not be fired for slacking off, nor could a good worker be rewarded for working hard. Under this system, workers had little or no incentive to produce high-quality goods. They also lacked any incentive to innovate in order to increase productivity. As a result, production was slow, and the goods produced were often shoddy, far inferior to those produced in a market economy.

The Soviet Union and other command economies did succeed in increasing economic equity and economic security for their people. But what good is a guaranteed income if there is nothing to buy? What markets do effortlessly, command economies struggle to do, usually with dismal results. Central planning was so inefficient and wasteful that the Soviet Union economy eventually collapsed. Since then, virtually all modern command economies have either failed or struggled to introduce market-based reforms.

## How Do Mixed Economies Divide the Decision Making?

No country in the world today relies on a purely traditional, market, or command economic system. These systems represent theoretical extremes. Nearly all countries have mixed economies that fall somewhere in between these extremes. In a **mixed economy**, both the government and individuals play important roles with regard to production and consumption. But who decides what varies from one country to another.



### Government's Role in a Mixed Economy: Protection, Regulation, and Public Benefits

Every nation with a mixed economy forges its own balance between market freedom and government involvement. At the minimum, governments are needed to establish the institutions that enable markets to operate. Such institutions include a legal system to enforce laws and a stable system of currency. Most of us never think about these things, but markets cannot function without them.

In many countries, people expect government to go further. They want it to step in when the market operates in ways that society finds unacceptable. For example, many nations outlaw child labor. Some governments limit the amount of pollution that industries can discharge. In the United States, the government regulates the manufacture of cosmetics, foods, and drugs because consumers want to know that products on the market are safe. Not all governments regulate to the same degree. Each society decides how far it wants its government to go in curtailing the freedom of the market.

Finally, government provides certain goods and services that markets do not always provide or do not provide enough of. Examples include **public works**, or government-financed projects such as dams, highways, and sewer systems. The market does not provide these goods because, as Adam Smith explained, the cost of providing them “could never repay the expense to any individual or small number of individuals.”

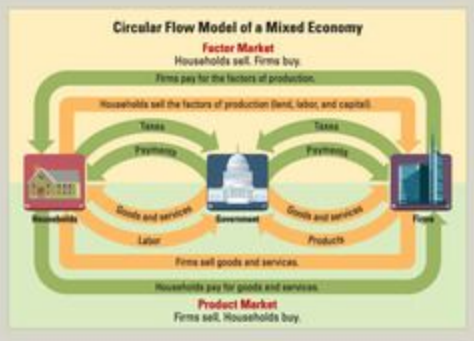
What a government provides varies from country to country. In Canada and much of Europe, health care is provided free to every citizen. Some governments provide free college education or free day care. Governments that provide a high level of goods and services also tax heavily to pay for those goods and services. Again, these are economic choices that every nation makes differently.

Figure 3.4A

**Modeling a Mixed Economy**

This economic model shows how government affects the flow of money, goods, and resources in a mixed economy.

- Households supply taxes and labor to the government.
- Firms supply taxes and products to the government.
- The government supplies services to households and firms. It also pays households and firms for their labor and products, as well as sending transfer payments to households.



**The Flow of Goods and Money in a Mixed Economy**

How does government participation in the economy change the flow of money and goods? The answer to this can be seen by adding government to the circular flow model. The revised circular flow model in Figure 3.4A shows a mixed economy with three participants: households, firms, and government.

A government enters the flow of money and products through an economy in a number of ways. It purchases land, labor, and capital from households in the factor market. In the United States, the federal government employs almost 2 million people, making it the nation's largest employer. A government also purchases goods and services from firms in the product market. As the nation's largest employer, the federal government is also its largest customer, spending hundreds of billions of dollars a year on goods and services.

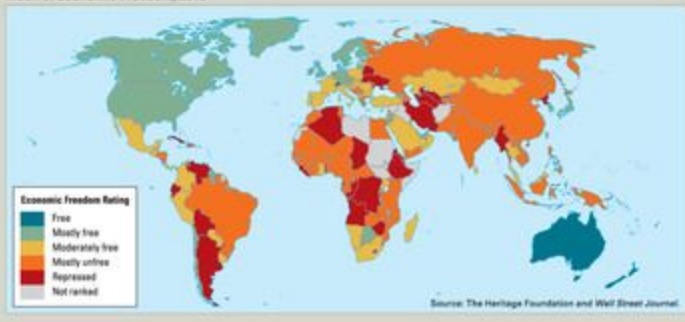
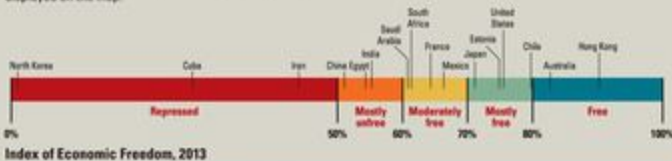
Governments also combine land, labor, and capital to produce and distribute goods and services. As an example, suppose a town decides it needs a library. The town government buys land and hires architects and builders in the factor market. Later, the town buys books, shelves, computers, and furniture in the product market. Finally, it hires librarians in the factor market. The end result is a public service that the entire community can enjoy.

Now follow the flow of money in a mixed economy. You will see that a government collects taxes from both households and firms. It uses some of this money to pay for the goods and services it buys from firms. It may also transfer some money back to households as payment for government benefits. Social Security checks, welfare payments, and unemployment benefits are examples of government [transfer payments](#).

Figure 3.4B

**Mapping Economic Freedom**

Whereas most countries today have mixed economies, the level of economic freedom their citizens enjoy varies widely. The Index of Economic Freedom ranks countries based on 10 indicators, including the ease of starting a new business, protection of property rights, and freedom from corruption. The 2013 rankings—from a high of 89 percent to a low of about 2 percent—are displayed on the map.



## **The Mixed Economy Continuum: From Free to Repressed**

Although most of today's economies can be described as mixed, the "mix" of market freedom and government control varies greatly from one nation to the next. In 2013, the Heritage Foundation and the *Wall Street Journal* published their annual Index of Economic Freedom. This index is a kind of scorecard that ranks the economic freedom of the world's nations. It is a useful tool for understanding the variety of mixed economies.

Near the top of the rankings is Australia, which was rated the third-most-free economy. Free markets dominate Australia's mixed economy. All banks are privately owned. The economy is open to foreign investment and trade. Private property is very secure. Starting a business is easy, taking an average of only two days.

At the very bottom of the list is North Korea, which came in last of the 157 ranked nations. A communist country since 1948, North Korea still has a tightly controlled command economy in which the government directs all industries and businesses. Nearly all foreign trade is forbidden and private property is severely restricted.

What about countries that fall somewhere in between, such as Japan, South Africa, and France? All three have mixed economies dominated by the market system. All have relatively high levels of economic freedom and secure property rights. But they also have high tax rates, which are used to pay for an array of public services and benefits, such as government-provided health care. In these nations, people have decided that achieving economic equity and security for more members of society is worth giving up some measure of their individual wealth.

Further down in the rankings is China, which is rated "mostly unfree." China, which has had a communist government since 1949, is in transition from a command economy to a market-oriented system. But its mixed economy is still dominated by an authoritarian government. All Chinese banks are owned by the state. Private property is not secure. Internet use is tightly controlled by the government.

Still, China allows more economic freedom than many countries. Iran, for example, is rated "repressed." Its economy is dominated by the state. The oil and gas industries are owned by the government, as are almost all banks. As in repressed North Korea, foreign investment in Iran is severely restricted. Iran's legal system does not uphold property rights or contracts.

Only four countries in the 2013 *Index of Economic Freedom*, plus Hong Kong, were rated "free." In addition to Australia, these countries are Singapore, New Zealand, and Switzerland. What do these countries have in common? All have mixed economies dominated by free markets. Most have democratic forms of government. They are also all among the wealthiest nations in the world. As Adam Smith might have predicted, the societies with the most economic freedom are also among the most prosperous.