

Unit #1: Foundations of Economics

Chapter #2: The Organization of Economies

In order to solve the problem of scarcity, societies must make choices. The basic economic questions are the main or basic choices that all societies must answer. These choices are influenced or guided by the rules or parameters set by each society. These rules or parameters compose the economic system.

The Basic Economic Questions

Because of scarcity every society or economic system must answer these three (3) basic questions:

1. What to produce?

- What should be produced in a world with limited resources?
- Exs) Using limited resources, should a local government build a new school or improve roads? Using limited resources, should a farmer grow wheat, cotton, or corn? Using limited resources, should an automobile manufacturer produce driverless cars?

2. How to produce?

- What resources should be used?
- Exs) How should we obtain oil? How much pollution should be allowed? How should we produce steel – using union or nonunion workers? Using recycled steel or iron ore?

3. Who consumes what is produced?

- Who acquires the product? How is it distributed?
- Exs) Who gets a flu vaccine? Where are new schools built? Who should clothes be produced for (what demographic group / generation)?

The goal in answering these questions is both **productive** and **allocative efficiency**.

- **Efficiency** is the goal of all economic decisions to solve the problem of scarcity. Thus, the aim of each society is to answer the above questions efficiently. There are two types of efficiency:
 - **Productive efficiency:** a situation in which the economy could not produce any more of one good without sacrificing production of another good.
 - ✓ Use all resources for lowest cost
 - **Allocative efficiency** is a state of the economy in which production represents consumer preferences.
 - ✓ Production that is valued by society: when supply meets demand
- We can't have everything we want, so we have to make use of resources in the best way possible. This is the basic tenet (main idea; theme) of economics.

Types Economic Systems or Economies

- The use on a specific economic system is how the basic economic questions are answered. Economic systems provide the rules or a framework for choices. They are chosen because society thinks it is the best way to meet the needs and wants of its citizens.
- **Traditional Economic System**
 - The traditional economic system is the most traditional and ancient types of economies in the world. Vast portions of the world still function under a traditional economic system. These areas tend to be rural, second- or third-world, and closely tied to the land, usually through farming. In general, in this type of economic system, a surplus would be rare, therefore the members of this economy would not have the ability to trade their excess for another person's excess. As a result, less will be enjoyed by each member than could be, and in economics, their quality of life would not be very high. Each

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member of a traditional economy has a more specific and pronounced role, and therefore the basic economic questions are answered according to the designations of the society, usually tradition and custom. These societies tend to be very close-knit and socially satisfied. However, they do lack access to technology and advanced medicine.

➤ **Command Economic System**

- In a command economic system, a large part of the economic system is controlled by a centralized power. For example, in the USSR most decisions were made by the central government. This type of economy was the core of the communist philosophy.
- Since the government is such a central feature of the economy, it is often involved in everything from planning to redistributing resources: deciding the answers to the basic economic questions of what to produce, how to produce, and who gets to acquire the product. A command economy is capable of creating a healthy supply of its resources, and it rewards its people with affordable prices. This capability also means that the government usually owns all the significant industries like utilities, aviation, and railroad.
- In a command economy, it is theoretically possible for the government to create enough jobs and provide goods and services at an affordable rate. However, in reality, most command economies tend to focus on the most valuable resources like oil.
- China, Cuba, and the Democratic People's Republic of Korea (DPRK; North Korea) are examples of command economies. However, due to changes beginning with the creation of Special Economic Zones in 1979, China has amounts of private ownership, and therefore elements of a market economy or capitalism.
- *Advantages of Command Economic Systems*
 - ✓ If executed correctly, the government can mobilize resources on a massive scale. This mobility can provide jobs for almost all of the citizens.
 - ✓ The government can focus on the good of the society rather than an individual. This focus could lead to a more efficient use of resources.
- *Disadvantages of Command Economic Systems*
 - ✓ It is hard for the central planners to provide for everyone's needs. This forces the government to ration because it cannot calculate demand since it sets prices.
 - ✓ There is a lack of innovation since there is no need to take any risk. Workers are also forced to pursue jobs the government deems fit.

➤ **Market Economic System**

- In a free market economy, firms and households act in self-interest to determine how resources get allocated, what goods get produced and who buys the goods. In other words, consumers and producers, through demand and supply, answer the basic economic questions. This is opposite to how a command economy works, where the central government answers them in their interest.
- There is no government intervention in a pure market economy ("laissez-faire"). However, no truly free market economy exists in the world. For example, while America is a capitalist nation, our government still regulates (or attempts to control) fair trade, government programs, business monopolies, etc.
- In this type of economy, there is a separation of the government and the market. This separation prevents the government from becoming too powerful and keeps their interests aligned with that of the markets.

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- Hong Kong has been seen as an example of a free market society (However, as China begins to exert more control, this may not last).
- *Advantages of a Free Market Economy*
 - ✓ Consumers pay the highest price they want to, and businesses only produce profitable goods and services. There is a lot of incentive for entrepreneurship. This leads to the most efficient use of the factors of production since businesses are very competitive.
 - ✓ Businesses invest heavily in research and development. There is an incentive for constant innovation as companies compete to provide better products for consumers.
- *Disadvantages of a Free Market Economy*
 - ✓ Due to the fiercely competitive nature of a free market, businesses will not care for the disadvantaged like the elderly, disabled, and those who lack skills. This leads to higher income inequality.
 - ✓ Since the market is driven solely by self-interest, economic needs have a priority over social and human needs like providing healthcare for the poor. Consumers can also be exploited by monopolies.
- **Mixed Economic System or a Mixed Market Economy**
 - A mixed economy is a combination of different types of economic systems. This economic system is a cross between a market economy and command economy. In the most common types of mixed economies, the market is more or less free of government ownership except for a few key areas like transportation or sensitive industries like defense and railroad. Hence, consumers and producers answer the basic economic questions through supply and demand, while the government may also answer them.
 - However, the government is also usually involved in the regulation of private businesses. The idea behind a mixed economy was to use the best of both worlds – incorporate policies that are socialist and capitalist.
 - To a certain extent, most countries are mixed economic system. For example, the United States, India and France are mixed economies.
 - *Advantages of Mixed Economies*
 - ✓ There is less government intervention than a command economy. This means that private businesses can run more efficiently and cut costs down than a government entity might.
 - ✓ The government can intervene to correct market failures. For example, most governments will come in and break up large companies if they abuse monopoly power.
 - ✓ Governments can create safety net programs like healthcare or social security.
 - ✓ In a mixed economy, governments can use taxation policies to redistribute income and reduce inequality, as well as provide for public goods like roads, community centers, and schools.
 - *Disadvantages of Mixed Economies*
 - ✓ There are criticisms from both sides arguing that sometimes there is too much government intervention and sometimes there isn't enough.
 - ✓ A common problem is that the state run industries are often subsidized by the government and run into large debts because they are uncompetitive.

Source: <https://www.intelligenteconomist.com/types-of-economies/>