

Economic Systems

GUIDE TO READING

Section Preview

In this section, you will learn about the different types of economic systems that govern WHAT goods and services to produce, HOW to produce them, and FOR WHOM to produce them.

Content Vocabulary

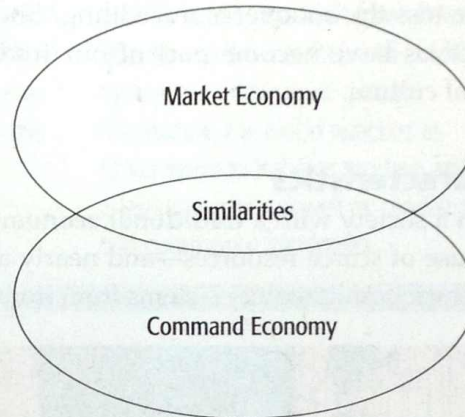
- economic system (p. 33)
- traditional economy (p. 34)
- command economy (p. 35)
- market economy (p. 37)
- market (p. 37)
- capitalism (p. 38)
- mixed economy (p. 39)
- socialism (p. 39)
- communism (p. 39)

Academic Vocabulary

- stagnation (p. 35)
- allocate (p. 36)
- emphasizing (p. 36)

Reading Strategy

Comparing and Contrasting As you read the section, complete a graphic organizer like the one below to identify ways in which a market economy differs from, and is similar to, a command economy.



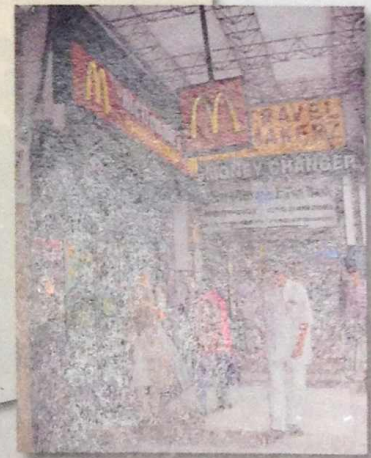
COMPANIES IN THE NEWS

—Global Business Today

McDonald's and Hindu Culture

For thousands of years, India's Hindu culture has revered the cow. Hindu scriptures state that the cow is a gift of the gods to the human race. . . . [The cows] are everywhere, ambling down roads, grazing in rubbish dumps and resting in temples—everywhere, that is, except on your plate, for Hindus do not eat the meat of the sacred cow.

. . . McDonald's responded to this cultural food dilemma by creating an Indian version of its Big Mac—the “Maharaja Mac”—which is made from mutton. . . . According to the head of McDonald's Indian operations, “We had to reinvent ourselves for the Indian palate.” ■



When companies want to do business in other countries, they need to adjust their business plans to meet local customs. This is what McDonald's corporation had to do when it expanded to India. While India's economy shares many characteristics with the United States, many of its business practices are based on a more traditional economic system.

All societies use an **economic system**—an organized way of providing for the wants and needs of their people. The way societies organize themselves determines the type of economic system they have. Three major kinds of economic systems exist—traditional, command, and market economies. In practice, however, almost all economies, like that of India, combine elements of all three.

economic system
organized way in which a society provides for the wants and needs of its people

Economics ONLINE

Student Web Activity Visit the *Economics: Principles and Practices* Web site at glencoe.com and click on Chapter 2—Student Web Activities for an activity on the economies of traditional societies.

traditional economy economic system in which the allocation of scarce resources and other economic activities are based on ritual, habit, or custom

Traditional Economies

MAIN Idea Traditional societies use ritual, habit, or custom to answer the basic questions of WHAT, HOW, and FOR WHOM to produce.

Economics & You Does your family have a tradition that has been passed down from generation to generation? Read on to learn how traditions govern the economies of some societies.

Many of our actions spring from habit and custom. Why, for example, does the bride toss the bouquet at a wedding? Such practices have become part of our traditional culture.

Characteristics

In a society with a **traditional economy**, the use of scarce resources—and nearly all other economic activity—stems from ritual,

habit, or custom. Habit and custom also dictate most social behavior. Individuals are generally not free to make decisions based on what they want or would like to have. Instead, their roles are defined by the customs of their elders and ancestors.

Examples

Many societies—such as the central African Mbuti, the Australian Aborigines, and other indigenous peoples around the world—have traditional economies. The Inuit of northern Canada in the 1800s provide an especially interesting case of a traditional economy.

For generations, Inuit parents taught their children how to survive in a harsh climate, make tools, fish, and hunt. Their children, in turn, taught these skills to the next generation. When the Inuit hunted, it was traditional to share the spoils of the hunt with other families. If a walrus or bear was taken, hunters divided the kill evenly into as many portions as there were heads of families in the hunting party. The hunter most responsible for the kill had first choice, the second hunter to help with the kill chose next, and so on. Because the Inuit shared freely and generously with one another, members of the hunting party later shared their portions with other families who had not participated.

The result was that the hunter had the honor of the kill and the respect of the village, rather than a physical claim to the entire animal. Because of this tradition of sharing, a village could survive the long, harsh winters as long as skilled hunters lived in the community. This custom was partially responsible for the Inuit's survival for thousands of years.

Advantages

The main advantage of a traditional economy is that everyone knows which role to play. Little uncertainty exists over

Traditions This woman in Botswana weaves a basket based on methods handed down by her ancestors. *What are the main characteristics of a traditional economy?*





The Great Wal [Mart] of China

What do you and 1 billion Chinese consumers have in common? Access to a Wal-Mart store. China's membership in the World Trade Organization has opened the door for capitalist companies to do business in this communist country. Now a growing number of Wal-Marts—48 and counting—cater to China's upper-middle class. Chinese consumers are pleased with the cleanliness and convenience Wal-Mart has to offer. Joe Hatfield, president and CEO of Wal-Mart Asia, explains that while Chinese grocers use fans to scatter flies, "They hold us to a higher standard than others and to set the expectations for others to follow."

While each new store creates roughly 500 new jobs, the retailer's presence in China does not come without

controversy. Opponents deride the company's low wages—between \$84 and \$96 per month—and argue that Wal-Mart encourages exploitation of Chinese workers. Headlines detailing the power struggle between the All-China Federation of Trade Unions (ACFTUS) and Wal-Mart have drawn attention to the retailer's anti-union stance in a communist country. Meanwhile, the world watches as China seeks to balance modern and traditional ways, as well as capitalist and communist ideologies.



WHAT to produce. If you are born into a family of hunters, you hunt. If you are born into a family of farmers, you farm. Likewise, little uncertainty exists over HOW to produce, because you do things much the same way your parents did. Finally, the FOR WHOM question is determined by the customs and traditions of the society. In some societies, you would provide for your immediate family. In others, such as the Inuit, you would share what you have hunted with all families of the village. In other words, tradition dictates how people live their lives.

Disadvantages

The main drawback of a traditional economy is that it tends to discourage new ideas and new ways of doing things. The strict roles in a traditional society have the effect of punishing people who act differently or break the rules. The lack of progress leads to economic stagnation and a lower standard of living than in other economic systems.

✓ Reading Check Describing What are the advantages and disadvantages of a traditional economy?

Command Economies

MAIN Idea Command economies rely on a central authority to make most of the economic decisions.

Economics & You As you make career decisions, does the government or other authority tell you what to do? Read on to find out how decisions are made in a command economy.

In a **command economy**, a central authority makes the major decisions about WHAT, HOW, and FOR WHOM to produce. A command economy can be headed by a king, a dictator, a president, or anyone else who makes the major economic decisions.

Characteristics

In a pure command economy, the government makes the major economic decisions. This means that the government decides if houses or apartments will be built. It also decides on the best way to build them, as well as who will receive them.

Most command economies severely limit private property rights. People are not allowed to own their homes, businesses, and

command economy economic system with a central authority that makes the major economic decisions



S

Consumer Goods Command economies often limit the production of consumer goods. The result is sparsely stocked shelves, such as in this store in Pyongyang, North Korea. *Why might command economies lack consumer goods?*

other productive resources, although they may have some personal items and tools.

R Individual freedom also is limited. For example, if the government wants engineers rather than social workers, then its universities will train more engineers. This limits individual choices because people have to live within the government's restrictions.

Finally, government officials tend to favor themselves when making economic decisions. The result is that some of the country's money often goes to luxury goods like houses, cars, and extravagant vacations for these officials.

Examples

Because they tend to be unproductive, few pure command economies exist today. North Korea and Cuba are modern examples, but in the 1970s and 1980s, the

communist bloc countries of the former Soviet Union had command economies.

In the former Soviet Union, for example, the State Planning Commission determined needs, set goals, and established production quotas for major industries. If it wanted growth in heavy manufacturing, it would **allocate** resources to that sector. If it wanted to strengthen national defense, it directed resources to military production.

Advantages

The main strength of a command system is that it can change direction drastically. The former Soviet Union went from a rural agricultural society to an industrial nation in a few decades by **emphasizing** the growth of heavy industry. During this period, the central planning agency shifted resources on a massive scale.

Another advantage of command economies, especially those represented by the former Soviet Union, is that many health and public services are available to everyone at little or no cost.

Disadvantages

Pure command economies have their disadvantages. One is that they ignore the basic wants and needs of consumers. In the Soviet Union, for example, generations of people were forced to do without consumer goods and adequate housing. Similarly, the current North Korean government has put a strong emphasis on defense. In the meantime, the North Korean people have been suffering years of hunger. At times, the government even had to accept aid from international sources.

A second disadvantage is that the system gives people the incentive to fill their quotas instead of producing a good product. At one time in the former Soviet Union, quotas for electrical motors were measured in tons of output. Soviet workers then filled their quotas by producing the world's heaviest electrical motors.

A third weakness is that a command economy requires a large decision-making bureaucracy. In the former Soviet Union, an army of clerks, planners, and other administrators was needed to operate the system. This structure slowed decision making and raised the cost of production.

Yet a fourth weakness is that the planning bureaucracy lacks the flexibility to deal with minor day-to-day problems. As a result, command economies tend to lurch from one crisis to the next—or collapse completely, as did the former Soviet Union.

Finally, rewards for individual initiative are rare in a command economy. Each person is expected to perform a job in a factory or on a farm according to the decisions made by central planners.

✓ Reading Check Analyzing What are the major problems with a command economy?

Market Economies

MAIN Idea In a market economy, consumers and businesses jointly answer the questions of WHAT, HOW, and FOR WHOM to produce.

Economics & You Name one or two things you like about the economic system in the United States. Read on to learn about the advantages of a market economy.

In a **market economy**, people make decisions in their own best interest. In economic terms, a **market** is an arrangement that allows buyers and sellers to come together to exchange goods and services. A market might be in a physical location, such as a farmers' market, or on an Internet site, such as eBay. Regardless of its form, a market can exist as long as a mechanism is in place for buyers and sellers to meet.

Characteristics

A market economy is characterized by a great deal of freedom. People can spend their money on the products they want most, which is like casting dollar "votes" for those products. This tells producers which products people want, thus helping them answer the question of WHAT to

market economy economic system in which supply, demand, and the price system help people make economic decisions and allocate resources

market meeting place or mechanism that allows buyers and sellers to come together (also see page 15)

Market

Economies In a market economy, people have the freedom to start any business they wish. *How do the two entrepreneurs in the cartoon reflect this freedom of choice?*



"Forget lemonade. The real money's in bottled water."

ism
ic system in
private citizens
d use the
of production in
to generate

produce. Businesses are free to find the best production methods when deciding HOW to produce. Finally, the income that consumers earn and spend in the market determines FOR WHOM to produce.

Market economies also feature the private ownership of resources. A market economy is often described as being based on **capitalism**—an economic system where private citizens own the factors of production. The term *capitalism* draws attention to the private ownership of resources, while the term *market economy* focuses on where the goods and services are exchanged. As a result, the two terms focus on different features of the same economy.

Examples

Many of the most prosperous economies in the world, such as the United States, Japan, South Korea, Singapore, Australia, Great Britain, and parts of Western Europe, are based on markets and capitalism. While there are significant differences among them, these economies share the common elements of markets and the private ownership of resources to seek profits.

Advantages

The first advantage of a market economy is its high degree of individual freedom. People are free to spend their money on almost any good or service they choose. They also are free to decide where and when they want to work, or if they want to invest further in their own education and training. At the same time, producers are free to decide whom they want to hire, which inputs they want to use, as well as the way they want to produce.

R The second advantage of a market economy is that it adjusts gradually to change over time. Prior to 2005, for example, gasoline prices were low, so people tended to buy large gas-guzzling SUVs. When the price of gas rose sharply in that year, SUV sales fell, and smaller, more fuel-efficient vehicles became popular.

A third advantage is the relatively small degree of government interference. Except for certain concerns such as national defense, environmental protection, and some care for the elderly, the government normally tries to stay out of the way of buyers and sellers.

s Handbook
ge R43 to
about
aring and
isting.

Figure 2.1 ▶ Comparing Economic Systems

	Traditional	Command	Market
Advantages	<ul style="list-style-type: none"> • Sets forth certain economic roles for all members of the community • Stable, predictable, and continuous life 	<ul style="list-style-type: none"> • Capable of dramatic change in a short time • Many basic education, health, and other public services available at little or no cost 	<ul style="list-style-type: none"> • Individual freedom for everyone • Able to adjust to change gradually • Lack of government interference • Decentralized decision making • Incredible variety of goods and services • High degree of consumer satisfaction
Disadvantages	<ul style="list-style-type: none"> • Discourages new ideas and new ways of doing things • Stagnation and lack of progress • Lower standard of living 	<ul style="list-style-type: none"> • Does not meet wants and needs of consumers • Lacks effective incentives to get people to work • Requires large bureaucracy, which consumes resources • Has little flexibility to deal with day-to-day changes • Lacks room for individual initiative 	<ul style="list-style-type: none"> • Rewards only productive resources; does not provide for people too young, too old, or too sick to work • Does not produce enough public goods such as defense, universal education, or health care • Workers and businesses face uncertainty as a result of competition and change

Every society has an economic system. The type of system that is best for a society depends on its ability to satisfy people's wants and needs and to fulfill its economic goals.

Economic Analysis Which economic system do you think is best able to provide for the wants and needs of individuals, and why?

A fourth advantage is that decision making is decentralized. Billions, if not trillions, of individual economic decisions are made daily. Collectively, people make the decisions that direct scarce resources into the uses consumers favor most, so everyone has a voice in the way the economy runs.

A fifth advantage of the market economy is the variety of goods and services. You can find ultrasound devices to keep the neighbor's dog out of your yard, or you can download music and video to your cell phone. In short, if a product can be imagined, it is likely to be produced in hopes that people will buy it.

A sixth advantage is the high degree of consumer satisfaction. In a market economy, the choice one group makes does not affect the choices of other groups. If 51 percent of the people want to buy classical music, and 49 percent want to buy rap music, people in both groups can still get what they want.

Disadvantages

The market economy does not provide for everyone. Some people may be too young, too old, or too sick to earn a living or to care for themselves. These people would have difficulty surviving in a pure market economy without assistance from family, government, or charitable groups.

A market economy also may not provide enough of some basic goods and services. For example, private markets do not adequately supply all of the roads, universal education, or comprehensive health care people would like to have. This is because private producers concentrate on providing products they can sell for a profit.

Finally, a market economy has a high degree of uncertainty. Workers might worry that their company will move to another country in search of lower labor costs. Employers may worry that someone else will produce a better or less expensive product, thereby taking their customers.

✓ Reading Check **Identifying** What are the main characteristics of a market economy?

Mixed Economies

MAIN Idea Most economies in the world today feature some mix of traditional, command, and market economies.

Economics & You You just learned about traditional, command, and market economies. Read on to learn how most societies combine elements of each.

While textbooks identify neat categories like traditional, command, and market economies, the real world is not so orderly. Most countries have **mixed economies**—systems that combine elements of all three types. When we consider political systems as well as economic systems, the picture gets even more complicated.

For example, **socialism** is a mixed economic and political system in which the government owns and controls some, but not all, of the basic productive resources. In socialistic countries, the government also provides some of the basic needs of its people, such as education and health care.

An extreme form of socialism is **communism**—a political and economic system where all property is collectively—not privately—owned. In a communist system, labor is organized for the common advantage of the community, and everyone consumes according to their needs. In practice, however, communist governments have become so involved in economic decisions that they are often called command economies.

D Characteristics

If government or tradition, as well as markets, answer *some* of the questions of WHAT, HOW, and FOR WHOM to produce, then a society has a mixed economy. The type of political system in a mixed economy is less important than the way basic economic decisions are made.

For example, some mixed economies have a political system based on democracy, and others do not. The state's involvement in economic decisions also can vary. Some governments provide only for basic needs such as defense, a justice system, and

W **mixed economy** economic system that has some combination of traditional, command, and market economies

socialism political and economic system in which the government owns and controls some factors of production

communism economic and political system in which all factors of production are collectively owned and controlled by the state

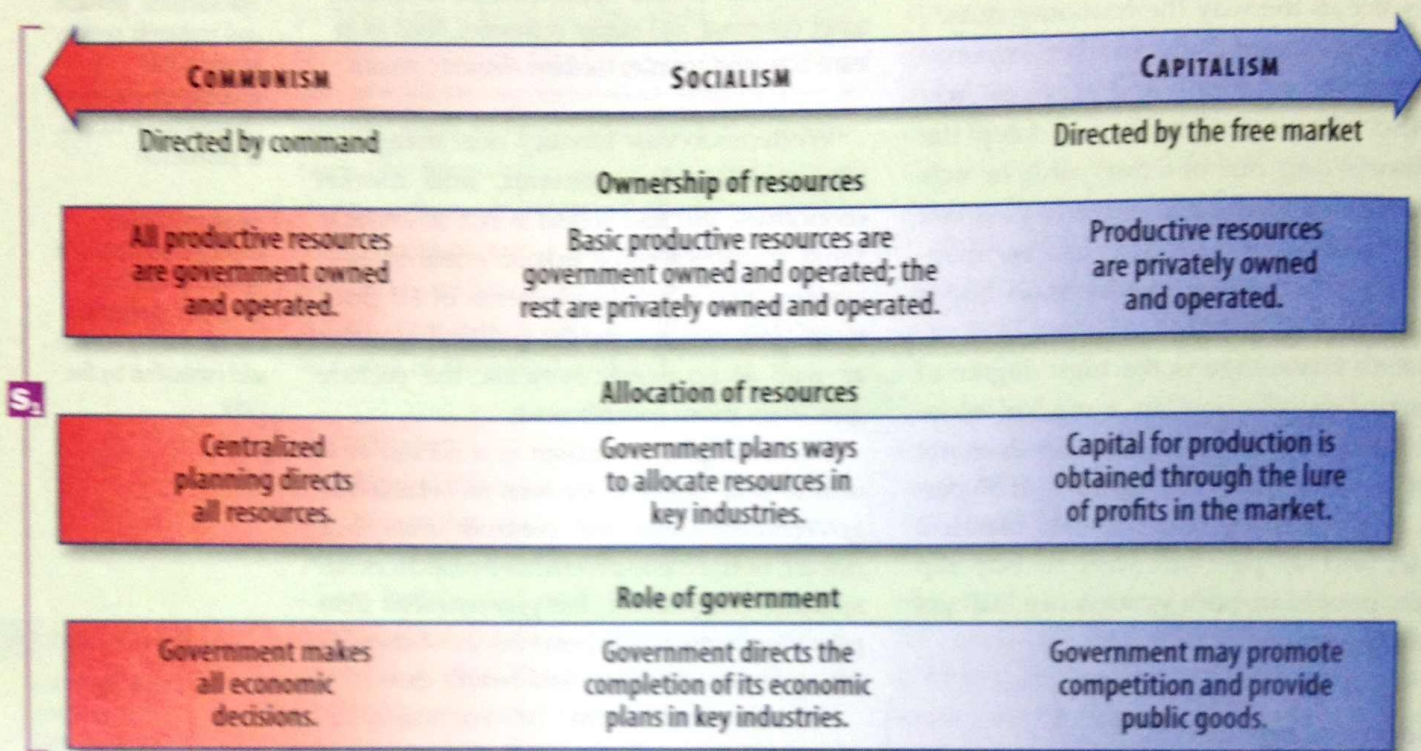
Figure 2.2 ▶ The Spectrum of Mixed Economies

Charts In Motion

See StudentWorks™ Plus
or glencoe.com.

- ▶ In mixed economies, government involvement can range from providing basic public goods to making most economic decisions.

Economic Analysis What distinguishes socialism from communism?



universal education. The more socialistic a country is, the more it will make major economic decisions, often with the claim that this is done for the betterment of the people. Some governments intervene only in certain key sectors or industries and leave the rest to markets. If the government intervenes too much, a mixed economy can turn into a command economy.

Examples

There is a wide range of mixed economies. China has a mixture of traditional, command, and market economies. While tradition has a strong influence in rural areas, the government makes many of the major economic decisions and owns many of the factors of production. China is changing, however. In recent years the government has allowed some private ownership of resources, and capitalism is beginning to flourish.

In Norway, the government owns the basic petroleum industry. It uses the revenue from the sale of oil to other nations to keep its domestic gas prices low, finance education, maintain roads, and provide social welfare for its citizens. Because the government controls just one industry, the mixed economy is based on capitalism and markets with some elements of socialism.

Cuba and North Korea today are very similar to the former Soviet Union, where a socialist government controlled resources to provide for all the people. However, the ownership and control of resources were so extensive that many economists thought of the country as a command economy.

Advantages

One advantage of a mixed economy is that it provides assistance for some people who might otherwise be left out. All societies

include some people who are too young, too old, or too sick to provide for themselves, for example, and most societies have traditions that address some of these concerns.

If the society has a democracy, voters can use their electoral power to affect the WHAT, HOW, and FOR WHOM decisions even if the government owns no productive resources. For example, the government can pass laws to provide aid for those most in need or to fund road construction.

Under socialism, the FOR WHOM question is addressed more directly. Ideally, those who are not fortunate or productive enough to take care of themselves still share certain benefits, such as free or low-cost public housing, transportation, medical care, and education.

Disadvantages

While mixed economies tend to provide more services, the costs for these benefits can mean higher costs for citizens overall. Germany, for example, offers a wide range of benefits, but it also has a high tax rate. During economic downturns, when the government collects fewer taxes, less

money is available for these programs. The German government has discussed placing limits on benefits, such as unemployment and welfare, because of lower revenues.

In some socialist countries, the availability of services may be limited or the quality may deteriorate over time. Today, for example, Cuba claims that it has free health care for everyone, but the care is substandard for everyone except high-ranking members of the Communist Party and those willing to pay for services in dollars.

Historically, both socialism and communism have proved to be less efficient than capitalism. For example, if workers receive government guarantees of jobs, more workers may be hired in a plant than are necessary, driving up production costs.

Because socialism has proved to be so inefficient, many socialistic countries today allow more capitalist development. This is especially true in China, where the emergence of capitalism has helped the country to become one of the major economic powers in the world today.

✓Reading Check **Explaining** How can you explain the range of mixed economies in the world?

SECTION

1

Review

Vocabulary

1. **Explain** the significance of economic system, traditional economy, command economy, market economy, market, capitalism, mixed economy, socialism, and communism.

Main Ideas

2. **Describing** Use a graphic organizer like the one below to describe how economic systems answer the basic economic questions.

	WHAT, HOW, and FOR WHOM?
Traditional economy	

3. **Explain** how a command economy differs from other economic systems.

Critical Thinking

4. **The BIG Idea** Why do market economies tend to be more efficient than traditional or command economies?
5. **Analyzing Visuals** Look at the chart on page 1. Does the top row show arrows on the left and right?
6. **Inferring** Why are market economies more efficient than either traditional or command economies?
7. **Analyzing** How does a traditional economy differ from a mixed economy like that of the United States?