Economic Systems

The way a **country's resources are owned and the way that country takes decisions as to what to produce, how much to produce and how to distribute what has been produced** determine the type of economic system that particular country practises.

1. MARKET ECONOMY (also called FREE ENTERPRISE ECONOMIES or CAPITALIST ECONOMY)
2. CENTRALLY – PLANNED or CONTROLLED ECONOMY
3. MIXED ECONOMY

1. MARKET ECONOMY in comparison to 2. PLANNED ECONOMY

1. MARKET ECONOMY

e.g. USA, Japan

Private firms or individuals own **means of production**. They make choices about:

- What to produce
- How to produce
- For whom to produce

- **What to produce** is answered by consumers according their demand for goods & services
- **How to produce** is answered by the business-men. They will choose the production method, which reduces their costs to reach the higher profit.
- **For whom to produce** – firms produce goods & services which consumers are willing and able to buy.

Role of government

1. To pass laws to protect businessmen & consumers
2. To issue money
3. To provide certain services – police
4. To prevent firms from dominating The market and to restrict the power Of trade unions
5. Repair and maintain state properties

Advantages:

- Goods and services go where they are most in demand and free market responds quickly to people's wants + wide variety of G&S
- No need for and overriding authority to determine allocation of goods&services
- Producers and consumers are free to make changes to suit their aims
- Competition and the opportunity to make large profits, greater efficiency, innovation

Disadvantages:

- It mis-allocates resources(to those with more $)
- It creates inequality of incomes
- It is not competent in providing certain services
- It leads to inefficiency (market imperfection)
- It can encourage the consumption of harmful goods - drugs

2. PLANNED ECONOMY

e.g. Cuba, China, former Soviet Union

State (government) owns all **means of production.** Individuals are not permitted to own any property. **Government + government planners** makes choices about What, How and For whom to produce.

- **What to produce** is answered by government planners, they make assumptions about consumers` needs and the mix of goods and services
- **How to produce** is answered by the gov. planners according the input-output analysis.
- **For whom to produce** – for consumers through state outlets. Prices can't change without state instructions. (Restrictions)

Role of government

1. Government make the most economic decisions with those on top of the hierarchy giving economic commands to those further down the ladder.
2. Government plans, organizes and coordinates the whole production process in most industries.
3. Government is the employer of most workers and tells them how to do their jobs.

Advantages:

- There is more equal distribution of wealth and income
- Production is for need rather than profit.
- Long-term plans can be made taking into account a range of future needs such as population changes and the environment.

Disadvantages:

- Vast bureaucracies employing – supervisors, coordinators…
- People are poorly motivated
- Planners often get things wrong – shortages of surpluses of some goods
- Poor standard of living

There are no pure free market economies or pure command economies. Because of:
Command economies are impossible to regulate all markets
Free market economies can't provide public goods (defence) and can't provide merit goods in sufficient quantity.

3. MIXED ECONOMY

All Western European countries
The balance between state provision (government planning) and free market provision is more or less equal. The government decides the "degree" of mixing. They will decide how much business activity there will be in the private sector and the public sector.

- In the countries, where the government plays important - major economic role the social provision will tend to be greater, taxed higher and distribution of wealth and income more equal. (Sweden)
- Whereas in countries where the private sector plays the most important economic role, social provision is lower with fewer free goods and services, also taxes will be lower and the distribution of wealth and income less equal.(GB)

Some resources are allocated by the government and the rest by the market system.
Most decisions are taken in the market place but the government plays an important role in modifying the functioning market.
Role of government

- Sets laws and rules that regulate economic life - intervention to control or regulate markets
- Provide certain services e.g. education, police, defense healthcare
- Regulate business – to ensure that there is fair competition in the private sector
- Restricts the consuming harmful goods by making them illegal or placing high taxes on them
- Planning gives the government the power to give G&S, or money to the poorer people

PUBLIC SECTOR – is responsible for the supply of public goods & services and merit goods. These goods are provided free when used and are paid by taxes e.g. roads, healthcare, street lighting
The central or local government makes decisions regarding resource allocation in the public sector.
In public sector, the state owns a significant proportion of production factors.
PRIVATE SECTOR – firms in response to the demand or consumers needs and wants make production decisions
In the private sector individuals are allowed to own the factor of production.

Businesses are set up in this system by individuals to supply a wide variety of goods and services. Competition exists between these firms.

THE ROLE OF GOVERNMENT IN A MARKET (MIXED) ECONOMY

There are various opinions of various economic thoughts about the role of government interventions.
Governments are generally argued to have four **main macroeconomic goals**:

- to maintain full employment
- to ensure price stability
- to achieve high level of economic growth
- to keep exports and imports in ballance

Fiscal policy

Government attempts to manipulate its budget deficit or surplus to achieve economic goals are called fiscal policy. It is generally any gov. decision about spending, taxes and borrowing. Using this policy government can easily influence aggregate demand.

There are 2 types of instruments of fiscal policy:
a/ **automatic (built in)stabilizers -** are expenditures that automatically increase when the economy is going into a recession. Conversely, they automatically fall when the economy booms. Automatic stabilizers include: - progressive income tax

- unemployment insurance
- subsidies to agricultural products
- government purchase of excessive agricultural products

b/ **active - discretionary fiscal policy** - it is the deliberate manipulation of the government spending and taxes to influence the economy, for example changes in tax rates, changes in government expenditure structure.

Crowding-out effect - is the negative effect of the fiscal policy, when money from private sector of the economy is crowded out to the public sector (for example by selling state bonds or treasury bills). Therefor amount of money in private sector decreases and interest rates increase. Result - less investment in private sector.

Laffer´s curve shows the relationship between the tax rates and the incomes from taxes. It shows that the highest income is when the tax rate is 50%. The same income from taxes is at the rates of 25% as well as 75%. However, the tax rate should not be higher then 50% (forbidden area).

Expansive (inflationary) fiscal policy - policy encouraging increase in aggregate demand.
Short run expansive fiscal policy :

- results in increase in real output and employment if the resources are not used to produce maximum potential output
- results in increase in price level if real output is near the maximum potential output

Long run expansive fiscal policy :

- results in increase in price level (inflation), but the real output remains the same because of crowding out effect

Restrictive (deflationary) fiscal policy - policy restricting the aggregate demand
Short run restrictive fiscal policy:

- decreases real output and employment if the resources in the economy are not used to produce maximum potential output
- decreases the prices if real output is near the maximum potential output

Long run restrictive fiscal policy:

- decrease in price level
- decrease in nominal and real interest rate
- unchanged level of real output and unemployment if private investment replaces government expenditures

Monetary policy

Monetary policy is the attempt by government or a central bank to manipulate the money supply, the supply of credit, interest rates, or any other monetary variables, to achieve the fulfilment of policy goals such as price stability.
There are various definitions of the money supply ranging from M0 to M4. The central bank has the total control over M0. However, less than 1% of M4 is made up of notes and coins. So when the government wishes to control anything other than M0, it has to control the amount of money in the banking system and in the wider financial system, too.

There are two types of tools (instruments) of monetary policy:

a/ **direct** - regulation of loans by the government institutions, regulation of the credits on consumer goods

b/ **indirect** - there are 3 main tools:

- reserve ratio - determined by the central bank. It is the percentage of total deposits of a bank that has to be kept in the form of cash. If the central bank alters the value of the reserve ratio, it will actually influence the size of money supply. The higher the reserve ratio, the lower the size of money supply.
- discount rate - it is the rate at which the central bank lend money to the commercial banks in need. It directly influences interest rates of commercial banks. If it increases, the interest rates increase, too.
- open market operations - selling the bonds or treasury bills decreases the amount of money in the circular flow, buying them increases the size of money supply in the economy.

Expansive monetary policy - increases the amount of money in the circular flow of income.
Restrictive monetary policy - decreases the amount of money in the circular flow of income.

If the demand for money increases, the central bank can control either **interest rate** or **money supply**. There are 2 differnt opinions whether to control money supply or interest rate:
1. **The Keynesian economists** think that regulation of interest rates is important. They argue that it is important to regulate aggregate demand, which consists of investments, household spending, government expenditures and net exports. Investments are most dependent on the interest rates.
2. **The monetarists** argue that it is is important to control money supply. The base of their thinking is the quantitative theory of money, which says that money supply can influence price level (inflation) as well as real output (economic growth).

Income policy

Income policy is the policy designed to limit the growth of incomes directly. It can help to redice inflation caused by supply-side factors. By imposing maximum pay increases, the government breaks inflationary expectations and hence the cost push spiral and helps the economy return to price level stability.

Social policy

It is a policy whose main aim is to achieve certain social goals. There is no specific social policy. It is usually some kind of monetary or fiscal policy. Taxation is an example. Suppose the distribution of income is inequitable. To redistribute the income, the government can impose the taxes which reduce the income and wealth of richer groups in the society and use the money collected to increase the income and wealth of poorer groups.
When the government wants to improve the level of education, it can increase its spending on it and ehen it wants to improve the living standard of low paid workers, it can impose minimum wage. These are considered to be social policies but in origin they are fiscal.

Foreign trade policy

It is a policy that can influence the workings of international trade. All countries choose to adopt **protectionist policies** to some extent because they want to protect their economies from destruction by huge imports or dumping. These protectionist policies are called **trade barriers**. The most important ones are **tariffs** and **quotas**, but there are some others as well. A **tariff** is a tax on imported goods and sometimes called an import duty or a customs duty. It is used to **restrict imports** so that it raises the final price of imported goods, thus lowering the demand of them. A **quota** is a physical limit on the quantity of the good imported. It is an example of a physical control.