An **economic system** is society's way of coordinating the production and consumption of goods & services.

Possible Goals of an Economic System

There are six main possible goals of an economic system:

Economic Freedom. Economic freedom is the ability to make our own economic decisions without interference from the government. A society that values economic freedom gives individuals & businesses the right to make decisions about how to use their resources. In a society that emphasizes economic freedom, government limits its interference in markets. They generally avoid things like price controls, high minimum wage laws, and a lot of burdensome government regulation that inhibits the ability for businesses to start and operate.

Economic Efficiency. An economic system whose goal is economic efficiency seeks to allocate resources in such a way that the greatest number of consumers get what they want with the least amount of waste. The economic system strives for full employment because unemployed workers are a wasted resource. In a society that emphasizes economic efficiency, the government limits what it does with taxation and government spending. It tries to minimize the amount it taxes from its citizens (including the businesses operating there) so that more money is available for both businesses & individuals.

Economic Equity. An economic system whose goal is economic equity is a society that seeks a "fair" and "just" distribution of a society's wealth. The issue here is the definition of "fair" and "just." "Fair" and "just" are very vague and subjective terms. One person's "fair" may not be the same as another person's "fair". A society that emphasizes economic equity has laws in place that pursue transfers of wealth from those that make more in society to those that make less. This is normally done in the form of higher rates of taxation on higher earners combined lower (or no) taxation on lower income earners, with more goods and/or services given by the government to lower income earners (anything from high levels of welfare payments, food stamps, medical care, cell phones, etc.) so those lower-income earners have to spend less of the money they earn on those items (giving them more disposable income).

Economic Growth. An economic system whose goal is economic growth is a society in which the economy produces more and better goods & services. Over time, this leads to a higher standard of living for all the residents in that country. Key element in accomplishing this is scientific & technological innovation. In a society that values economic growth, the government limits its interference in the markets except for relatively high government spending on scientific & technological innovation (either through grants or tax credits).

Economic Security. An economic system whose goal is economic security seeks to provide the less fortunate in society with the support they need in terms of food, shelter, & health care to live decently. In a society that values economic security, the government establishes a substantial social "safety net" that includes things like welfare, Medicaid, unemployment, food stamps, etc., to those in their society whom they believe can't afford those things on their own.

Economic Stability. An economic system whose goal is economic stability seeks to eliminate economic uncertainty. They want to ensure that the goods & services those in the society want are there when they want them. They want to be secure that their jobs are there when they go to work each day. They also want prices that are predictable, allowing them to plan ahead for purchases. In a society that values economic stability, the government uses its control of its money supply and spending to manipulate growth in the economy to keep it slow. The slower the growth of an economy, the less severe the crashes in that economy.

These different goals are not mutually exclusive, meaning that a society picks only one and pursues it at the expense of all the others. All societies pursue most or all these goals to varying degrees. Each society just places a different level of importance, and a different level of emphasis, on each goal.

Possible Goals of an Economic System

Economic Freedom
The ability to make our own economic decisions without interference from the government.

Economic Efficiency
The allocation of resources in such a way that the greatest number of consumers get what they want with the least amount of waste.

Economic Equity
A "fair" and "just" distribution of a society's wealth.

Economic Growth
The economy produces more and better goods and services.

Economic Security
Provide the less fortunite in society with the support they need in the terms of food, shelter, & health care.

Economic Stability
Elimination of uncertainty for job security, wages, & prices.

The Basic Economic Questions

All economic systems pursue their economic goals by who in the economy makes the decisions on the following economic questions:

What to produce – What goods & services will be produced in that economy?

How to produce – How will the productive resources in the economy be used to produce the goods & services?

For whom to produce – Who in society will have access to the results of the production?

Productive Resources: The Factors of Production

The *How to Produce* question is answered when that economic system decides how to organize the productive resources in its economy. Productive resources are normally referred to as the ***factors of production***. These are the inputs that go into the production of goods & services that will satisfy the economic wants of the society. All economic systems have the following productive resources:

Natural Resources. Natural resources are also referred to by the generic term **land**. They are the "gifts of nature". There are three main categories of natural resources:

Perpetual resources – these are resources that are widely available and in no danger of being used up. Some examples include land, sunlight, wind, etc.

Renewable resources – these are resources that can be replaced as they are used. Some examples of renewable resources are forests, plants/crops, fresh water, fish, livestock, etc., because they can all be replenished (grow more crops, breed more livestock, etc.).

Non-renewable resources – these are resources that, once used, they are gone forever. Some examples of non-renewable resources are oil, coal, natural gas, etc. These natural resources are not valuable in and of themselves; the value of natural resources depends on someone knowing how to plug them into the production process. For example, before someone figured out what to do with oil, it had no value in society.

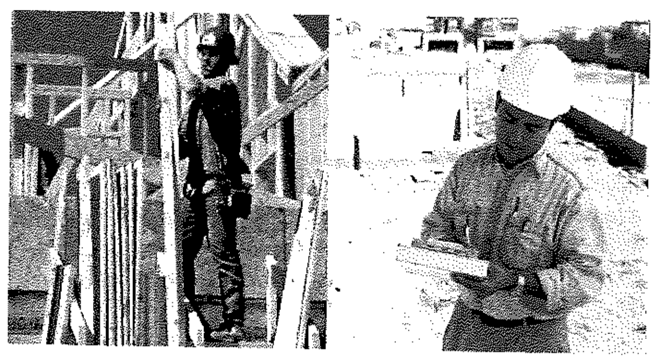
Natural resources (the "gifts of nature") can be *perpetual* (like water), renewable (like corn), or non-renewable (like oil).
(Images courtesy of Microsoft Photo Gallery)

Let's take a look at a common business: a retail store in the mall. There are several natural resources critical to that store's operations. The land on which the store sits is a perpetual resource. The electricity that the store uses is produced with a combination of non-renewable resources (coal, oil, and/or natural gas) and renewable resources (solar power, wind power).

Human Resources. Human resources are also referred to as **labor**. This is the time & effort people devote to producing goods & services in exchange for pay (wages). This can be ***physical labor***, like a construction worker, farmer, factory worker, landscaper, etc. This can also be ***mental activity***, like a lawyer preparing legal briefs, someone managing the finances for a business, etc.

Let's look at that same example of the store in the mall. It has a workers performing physical labor; there are employees stocking the shelves, processing the sales of the customers, and maintaining the cleanliness of the store. It also has workers performing mental activity, like the manager preparing the work schedule, the accountant maintaining the store's financial records, and the owner planning and deciding on what inventory (and how much) to stock on the shelves.

The quantity of labor available depends on the size of its population and the people's willingness to work. The quality of labor depends on how productive those workers are. This productivity of an individual worker is called ***human capital***.

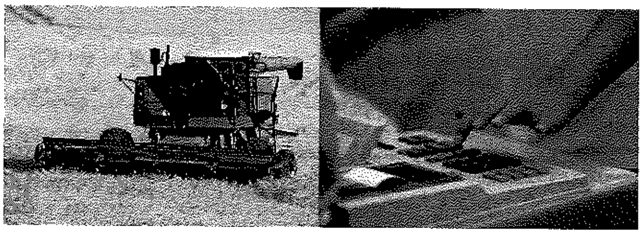


Human resources are both *physical labor* (like a carpenter) and *mental activity* (like a manager). The skills each provides, measured in terms of their productivity, are referred to as *human capital*.
(Images courtesy of Microsoft Photo Gallery)

Capital Resources. Capital resources are usually simply referred to as **capital**. However, there are two types of capital resources in an economy.

Physical Capital. Physical capital is also referred to as **capital goods**. These are the tools, machinery, factory buildings, inventories, etc. used to produce the final products made by a business.

Financial Capital. **Financial capital** is the money that is invested in businesses to produce future wealth. The money invested has a variety of uses; it can be used, for example, to purchase capital goods, to pay employees, and to pay other expenses (rent, utilities, insurance, advertising, etc.) for the business. Financial capital is needed to start and run business before first sale of a product ever takes place; this is referred to as *start-up capital*, and it comes from investment and/or loans. Financial capital is also needed as the business operates; this is referred to as *working capital*, and it comes from sales, loans, and/or additional investments in the business.



Capital resources include *physical capital* (everything from large pieces of machinery to small equipment like cash registers) and *financial capital* (the money used in starting up and operating the business).
(Images courtesy of Microsoft Photo Gallery)

A key concept as it relates to the use of a specific factor of production is **productivity**. Productivity is a measure of the output per unit of input. It is measured as

$$\frac{\text{OUTPUT}}{\text{INPUT}}$$

Let's get back to our example of the retail store at the mall. A sales clerk is making $9.00 per hour. That sales clerk averages $180 in sales per hour worked. The productivity of that sales clerk is $180 (the output) divided by $9 (the input), or 20:1 ($20 of output for every dollar the employee costs the business). If the sales clerk can generate $225 in sales for each hour worked, his/her productivity goes up to 25:1 ($25 in sales for each dollar the employee costs the business).

Businesses want to arrange their productive resources to maximize their productivity. They must decide how much land, labor, and physical capital to use to produce their products. Their goal is to maximize the productivity (measured in profits) of the amount they dedicate to their productive resources. If automating a process (like using a robot for a specific step in an assembly process instead of using a human worker to perform that step) will result in higher productivity, then the business will probably replace that worker with a robot.

What Defines an Economic System?

Economic systems are defined by who answers the 3 basic economic questions, and how they answer those questions. These economic systems usually also emphasize different economic goals.

There are four major types of economies:

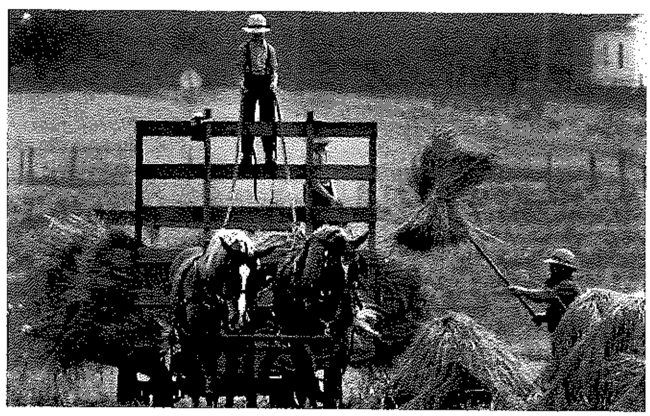
Traditional Economies. In traditional economies, the answers to the three basic economic questions are determined by *custom*. A good example of this is the Amish.

The question of *what to produce* in their economy determined by *societal customs*. The products they produce are what their society has always produced.

The question of *how to produce* is also driven by *societal customs*. The Amish don't use electricity, so everything they make is made by hand using unpowered hand tools. Also, males and females (and old and young) perform specific roles in their society, so that determines who does the farming, the cooking, etc., in their economy.

The question of *for whom to produce* also driven by *societal custom*. The Amish primarily produce everything to share within their society. They have, however, started to produce items to be sold to those outside of their society.

The primary economic goals of a traditional economy are *economic stability* and *economic security*. The Amish are mainly concerned with everyone in their society having the necessities of life, and being able to count on getting those necessities. They are not necessarily concerned with improvements in the standard of living, as their belief system determines what they should expect as their standard of living.



Amish society operates as a traditional economy. The three basic economic questions are all determined by social custom.
(Photo courtesy of Microsoft Photo Gallery)

Market Economies. In market economies, the answers to the three basic economic questions are determined by *individuals in the marketplace*.

The question of *what to produce* determined by *consumers* through what they demand in the marketplace. Producers only continue to produce what consumers demand. If consumers no longer want it, producers will no longer produce it. A good example of this is how we buy music. Originally, you bought music on records (vinyl discs) and listened to it on a record player.

Then, the 8-track tape and cassette tape were both developed, and you could buy music in any of these media. The 8-track lost its popularity. Customers stopped buying them, so producers stopped producing them. With the invention of the compact disc (CD), vinyl records and ultimately cassette tapes both lost their popularity. Consumers no longer buy them, so producers stopped producing them, too. Now, in the era of digital music, when you can purchase and download the music you want to a variety of devices, CDs are losing their popularity. This is referred to as **consumer sovereignty**: consumer demand will drive what producers produce.

The question of *how to produce* is determined by *producers* seeking to maximize productivity & profit. Producers will seek to use a mix of natural resources, human resources, & capital resources that minimizes necessary cost per unit of output. The choices of this mix are driven by what potential customers they want to appeal to. A good example of this is a comparison of Rolex watches and Timex watches. Rolex watches are made of the highest-quality components and are assembled by highly skilled craftsmen. Timex watches, on the other hand, are mass-produced in factories and are made of lower-quality components. Each manufacturer makes decisions about the mix of resources to use in order to appeal to their target customers and still minimize the necessary cost of producing the product relative to what those target customers are willing to pay. Producers don't always want to use cheap labor and cheap materials and still charge outrageous prices. They pay for the quality of labor, materials, machinery, etc., needed to produce the products their target customers are demanding. If a consumer wants an inexpensive version of some item, a producer that targets that customer will make an inexpensive version of that item. If a customer wants a high-end, high-quality item (and is willing to pay for it), a producer that targets that customer will produce that.

The question of *for whom to produce* determined by the *price* of the product. The consumer can buy whatever he/she wants, as long as he/she has the money to buy it. Except for a few products that the government wants to restrict who purchases them (military weapons, alcohol, tobacco, firearms, etc.), there are virtually no restrictions on who can buy what product, as long as he/she has the money. If you want to buy a Rolex watch, you can; there are no laws restricting who is permitted to buy a Rolex.

The primary economic goals of a market economy are *economic freedom* and *economic efficiency*. Individuals in the marketplace are allowed to try to satisfy their own wants and needs, and businesses are allowed to provide products to satisfy those wants and needs, both with minimal interference from the government (economic freedom). The productive resources (land, labor, and capital) are allowed to be used for their most valued uses with minimal waste and minimal interference from the government (economic efficiency).

In a market economy, consumer sovereignty determines what will be produced. Producers organize their productive resources in a manner that maximizes their productivity. The pricing system determines who will receive the results of production.
(Image courtesy of Microsoft Photo Gallery)

Command Economies. In command economies, the answers to the three basic economic questions are determined by *those in charge*. The original command economies were controlled by powerful rulers, like kings, pharaohs, or emperors. Their primary economic goals were to accumulate wealth and goods for the ruling class, and to provide economic stability for those in the working class.

Modern command economies use *central planning* by the state to answer the 3 basic economic questions. The questions of what to produce, how to produce, & for whom to produce are all determined by government central planning committees of economists, production experts, and political officials.

In a modern command economy, central planners decide what goods and services should be produced in that economy, and how much of each of those goods and services will be produced. Everything produced in that economy, from automobiles to bread, are dictated by the central planners. They also determine the quantity of each good and service that will be produced; this supply may not actually be what the actual demand for that good or service is, and there are usually shortages of most consumer goods.

Central planners also decide which farms and factories should get which resources to produce what was planned. They control prices and wages. The prices they determine for the various goods and services often are based on what the central planners believe a customer should pay and not actually reflect the cost of actually producing that good or service. They also control how much a worker is paid for a given job. They even dictate who is permitted to hold which job.

Central planners also decide how goods & services should be distributed. They dictate how many of a given good or service each citizen will be permitted to buy. The central planners dictate how much of a given good or service they believe an individual citizen "needs"; the desires of the individual citizen are irrelevant. For some items, like automobiles, a citizen must receive permission from the central planners before he/she is allowed to buy that item.

The primary economic goals of a command economy are *economic equity* and *economic security*. The philosophy is that everyone in that society should have equal access and equal ability to buy most items in that economy. By controlling the workforce and dictating who works what job, they ensure that all citizens are employed, even if that citizen is not working in a job he/she wants. All citizens are expected to sacrifice their individual desires (whether desired job or desired products to buy) to the "greater good" of the state.

In a command economy, central planners determine all aspects of production (what will be produced, how it will be produced, and who will get the products). Actual consumer demand was not taken into consideration, as the central planners only planned for what they though their citizens would "need" and not what the actually "want". This typically results in shortages of consumer goods, and the citizens normally had to wait in long lines to purchase even the most basic necessities, like this line for bread in the Soviet Union when it was still a command economy.
(Image courtesy of sodahead.com)

Mixed Economies

No economy is a true free-market economy. Governments all exert some degree of influence on economic activity. Likewise, no economy is a true command economy. Even the most controlling command economy still permits a limited amount of market activity. For example, Cuba (one of the most restrictive modern-day command economies) still allows some small entrepreneurs (restaurants, small retail shops) to own and operate their businesses. No economy is a true traditional economy. Market influences have crept into these systems. Governments exert some influence on how traditional economies operate. The Amish now buy and sell items from outside their society, and the U.S. and state governments do still enforce a variety of laws and regulations on the Amish.

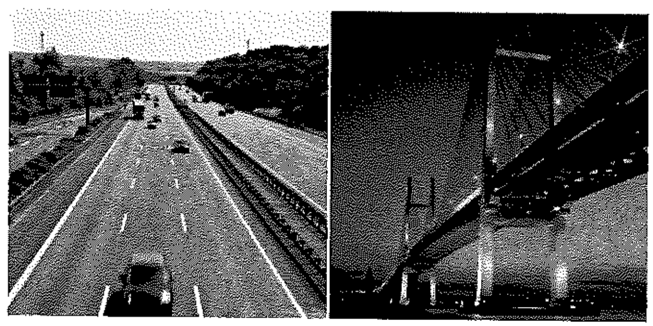
These types of economies (total command and total market) are theoretical extremes. In reality, all economies fall somewhere between these extremes. Every nation forges its own balance between market freedom and government involvement.

Government's Role in a Mixed Economy

Governments all play a role in their economy; how large a role they play, and the level of influence they have, varies from country to country. At very least, governments are needed to establish the institutions that enable markets to operate. They establish and maintain the legal system to enforce laws. They also establish and maintain a stable system of currency.

Protection & Regulation. Governments take actions to protect their citizens from the potential dangers of the economic activities by businesses. Some examples are child labor laws, pollution regulation, workplace safety regulation, and regulation of banks & other financial institutions.

Public Goods. Government provides for public goods. A **public good** is an item, once provided, is available to all without further opportunity cost. In other words, those who don't pay for good cannot be excluded from using it. This is known as the "free rider" problem. A **free rider** gets benefits without paying the costs. Private markets won't provide a good that people don't pay for. Some examples are roads, highways, and bridges. Once a road, highway, or bridge is built, it would be difficult to restrict its use.



Because of the free rider problem (someone being able to take advantage of the benefits of a product without paying the costs), governments provide for public goods like highways and bridges. Other examples of public goods include fire and police protection.
(Images courtesy of Microsoft Photo Gallery)

The Mixed Economy Continuum: From Free to Repressed

The "mix" of market freedom & government control varies greatly from one nation to the other. Countries can be evaluated based on the level of economic freedom they afford their citizens in their country. The Heritage Foundation releases an annual Index of Economic Freedom, evaluating 183 countries on the level of economic freedom based on criteria in 10 categories in 4 major areas. These criteria are shown on the chart on the next page. Those with high index numbers are toward the free-market end of the continuum; those with low index numbers are more repressed, and are probably command economies.

Criteria Evaluated to Determine the Economic Freedom of a Country

Rule of Law

Property Rights

- Does that country have a legal system that can be relied on to enforce the property rights of its citizens?
- Does that country have a legal system that can be relied on to enforce the contract rights of its citizens?

Freedom from Corruption

- Does that country effectively deal with government corruption?
- Does that country have a legal system that will protect businesses from having to pay bribes to government officials in order to be able to operate in that country?

Limited Government

Government Spending

- What level of the country's output is taken up by government spending?
- To what extent is the government burdening its population with debt, the repayment of which (including interest payments) will be a drain on future economic activity?

Fiscal Freedom

- Does the government take a large percentage of income earned by individuals and businesses in the form of income taxes?
- Does the government take a large percentage of income earned from investments made by individuals and businesses?

Regulatory Efficiency

Business Freedom

- How hard is it for a business to start and operate in terms of government regulations with which it must comply?

Labor Freedom

- To what extent do the government's laws concerning labor support the ability of employers and employees to come to mutually agreeable terms concerning wages, working conditions, etc.?

Monetary Efficiency

- Is the country's money supply stable, allowing for predictability in pricing for its businesses and individual citizens?

Open Markets

Trade Freedom

- Can businesses in the country trade freely with other countries?
- What types of trade barriers does the country have that prevent businesses from being able to trade with other countries?

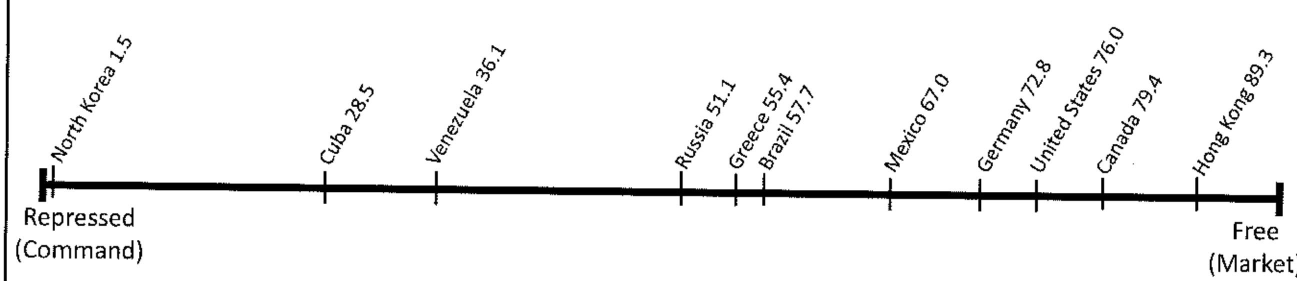
Investment Freedom

- How open is the country to foreign investment?

Financial Freedom

- How effective is its financial sector in connecting individuals and businesses with sources of financial capital for personal and business use?
- How risky is its banking sector?

2013 Country Rankings Based on the Heritage Foundation's Index of Economic Freedom



Country rankings & criteria for the Index of Economic Freedom courtesy the Heritage Foundation www.heritage.org/index