

Introduction of Economic Systems

- The subject Economics is classified into two branches, namely, Micro Economics and Macro Economics.
- Ragnar Frisch, a Norwegian economist and the co-recipient of the first Nobel Prize in Economic Sciences coined the words ‘micro’ meaning small and ‘macro’ meaning large in the year 1933.
- However, macroeconomics in its modern Form began with John Maynard Keynes and his book “The General Theory of Employment, Interest and Money” Published in 1936.
- Keynes offered an Explanation for fallout from the Great Depression, when goods remained unsold and workers unemployed.
- Hence, Keynes Is regarded as the ‘Father of Modern Macro Economics

Economic Systems:

- Economic System refers to the manner in which individuals and institutions are Connected together to carry out economic Activities in a particular area.
- It is the Methodology of doing economic activities to meet the needs of the society.

Three major types of economic systems.

They are:

- Capitalistic Economy (Capitalism),
- Socialistic Economy (Socialism)and
- Mixed Economy (Mixedism)
- Capitalism and socialism are two Extreme and opposite approaches.
- In Capitalism, there is total freedom and Private ownership of means of production.
- In socialism, there is no freedom for Private and there is public ownership of Means of production.
- Mixedism denotes the Co-existence of capitalism and Socialism.

Capitalistic Economy (Capitalism)

- **Adam Smith is the ‘Father of Capitalism’.**

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- Capitalistic economy is also termed as a free economy (Laissez faire, in Latin) or market economy where the role of the government is minimum and market determines the economic activities.
- The means of production in a capitalistic economy are privately owned.
- Manufacture Produce goods and services with profit motive.
- The private Individual has the freedom to undertake any occupation and develop any skill.
- The USA, West Germany, Australia and Japan are the best examples for capitalistic Economies.
- However, they do undertake Large social welfare measures to safeguard the downtrodden people from the market Forces.

Features of Capitalistic Economy:

- **Private Ownership of Property and Law of Inheritance:**
 - The basic feature of Capitalism is that all resources namely, Land, capital, machines, mines etc.
 - Are owned by private individuals.
 - The Owner has the right to own, keep, sell or use these resources according to his Will.
 - The property can be transferred to Heirs after death.
- **Freedom of Choice and Enterprise:**
 - Each individual is free to carry out any occupation or trade at any place and produce any commodity.
 - Similarly, Consumers are free to buy any Commodity as per their choice.
- **Profit Motive:**
 - Profit is the driving Force behind all economic activities in a capitalistic economy.
 - Each Individual and organization produces only those goods which ensure high Profit.
 - Advance technology, division of Labour, and specialisation are followed.
 - The golden rule for a producer under capitalism is ‘to maximize profit.

- **Free Competition:**

- There is free Competition in both product and Factor market.
- The government or any Authority cannot prevent firms from Buying or selling in the market.
- There is competition between buyers and Sellers.

- **Price Mechanism:**

- Price mechanism is the heart of any capitalistic economy.
- All economic activities are regulated through price mechanism i.e; market Forces of demand and supply.

- **Role of Government:**

- As the price Mechanism regulates economic activity, the government has a limited role in a Capitalistic economy.
- The government provides basic services such as, defense, public health, education, etc.

- **Inequalities of Income:**

- A capitalist Society is divided into two classes – ‘**haves**’ that is those who own property and ‘**have-nots**’ who do not own Property and work for their living.
- The Outcome of this situation is that the Rich become richer and poor become Poorer.
- Here, economic inequality goes on increasing.

Merits of Capitalism:

- **Automatic Working:** Without any Government intervention, the economy Works automatically.
- **Efficient Use of Resources:** All Resources are put into optimum use.
- **Incentives for Hard work:** Hard work is encouraged and entrepreneurs get more profit for more efficiency.
- **Economic Progress:** Production and Productivity levels are very high in Capitalistic economies.
- **Consumers Sovereignty:** All production Activities are aimed at satisfying the Consumers.

- **Higher Rates of Capital Formation:** Increase in saving and investment leads to higher rates of capital formation.
- **Development of New Technology:** As Profit is aimed at, producers invest on new technology and produce quality Goods.

Demerits of Capitalism:

- **Concentration of Wealth and Income:** Capitalism causes concentration of Wealth and income in a few hands and thereby increases inequalities of Income.
- **Wastage of Resources:** Large amount of resources are wasted on competitive Advertising and duplication of products.
- **Class Struggle:** Capitalism leads to Class struggle as it divides the society into capitalists and workers.
- **Business Cycle:** Free market system leads to frequent violent economic Fluctuations and crises.
- **Production of non-essential goods:** Even the harmful goods are produced if there is possibility to make profit.

Socialistic Economy (Socialism)

- **The Father of Socialism is Karl Marx.**
- Socialism refers to a system of Total planning, public ownership and State control on economic activities.
- Socialism is defined as a way of organizing a society in which major industries are owned and controlled by the government, a Socialistic economy is also known as 'Planned Economy' or 'Command Economy'
- In a socialistic economy, all the resources are owned and operated by the government.
- Public welfare is the main motive behind all economic activities.
- It aims at equality in the distribution of income and wealth and equal opportunity for all.
- Russia, China, Vietnam, Poland and Cuba are the Examples of socialist economies.
- But now there are no absolutely socialist economies.

Features of Socialism:

- **Public Ownership of Means of Production:**
 - All resources are owned by the government.
 - It means that all the Factors of production are nationalized and managed by the public authority Central Planning: Planning is an Integral part of a socialistic economy.
 - In This system, all decisions are undertaken by the central planning authority.
- **Maximum Social Benefit:**
 - Social Welfare is the guiding principle behind all economic activities.
 - Investments are planned in such a way that the benefits are distributed to the society at large.
- **Non-existence of Competition:**
 - Under the socialist economic system there is absence of competition in the Market.
 - The state has full control over Production and distribution of goods and services.
 - The consumers will have a limited choice.
- **Absence of Price Mechanism:** The Pricing system works under the control and regulation of the central planning Authority.
- **Equality of Income:**
 - Another essential Feature of socialism is the removal and Reduction of economic inequalities.
 - Under socialism private property and the law of inheritance do not exist.
- **Equality of Opportunity:**
 - Socialism Provides equal opportunity for all Through free health, education and Professional training.
- **Classless Society:**
 - Under socialism, there is a classless society and so no Class conflicts.

- In a true socialist society, everyone is equal as far as economic Status is concerned.

Merits of Socialism:

- **Reduction in Inequalities:** No one is allowed to own and use private property to exploit others.
- **Rational Allocation of Resources:**
 - The central Planning authority allocates the resources in a planned Manner.
 - Wastages are minimised and Investments are made in a pre-planned Manner.
- **Absence of Class Conflicts:**
 - As Inequalities are minimum, there is no Conflict between rich and poor class.
 - Society functions in a harmonious Manner.
- **End of Trade Cycles:**
 - Planning Authority takes control over production and distribution of goods and services.
 - Therefore, economic fluctuations can be avoided.
- **Promotes Social Welfare:** Absence of Exploitation, reduction in economic Inequalities, avoidance of trade cycles and increase in productive efficiency Help to promote social welfare.

Demerits of Socialism:

- **Red Tapism and Bureaucracy:** As Decision are taken by government Agencies, approval of many officials And movement of files from one table to other takes time and leads to red Tapism.
- **Absence of Incentive:**
 - The major Limitation of socialism is that this System does not provide any incentive for efficiency.
 - Therefore, productivity also suffers.
- **Limited Freedom of Choice:** Consumers do not enjoy freedom of Choice over the consumption of goods and services.

- **Concentration of Power:**

- The State takes all major decisions.
- The private takes no initiative in making economic Decisions.
- Hence, the State is more powerful and misuse of power can also take place.

Mixed Economy (Mixedism):

- In a mixed economy system both private and public sectors co-exist and work together towards economic development.
- It is a combination of both capitalism and socialism.
- It tends to eliminate the Evils of both capitalism and socialism.
- In these economies, resources are owned by individuals and the government.
- India, England, France and Brazil are the Examples of mixed economy.

Features of Mixed Economy:

- **Ownership of Property and Means of Production:**
 - The means of production and properties are owned by both Private and public.
 - Public and private have the right to purchase, use or transfer their resources.
- **Coexistence of Public and Private Sectors:**
 - In mixed economies, both Private and public sectors coexist.
 - Private industries undertake activities primarily for profit.
 - Public sector firms are owned by the government with a View to maximize social welfare.
- **Economic Planning:**
 - The central Planning authority prepares the Economic plans.
 - National plans are drawn up by the Government and Both private and public sectors abide.
 - In general, all sectors of the economy function according to the objectives, Priorities and targets laid down in the Plan.

- **Solution to Economic Problems:**

- The Basic problems of what to produce, how to produce, for whom to produce and how to distribute are solved through the price mechanism as well as state Intervention.

- **Freedom and Control:**

- Though private has freedom to own resources, produce Goods and services and distribute the same, the overall control on the Economic activities rests with the Government.

Merits of Mixed Economy:

- **Rapid Economic Growth:**

- The best Advantage of mixed economy is that it promotes rapid economic growth.
- Thus, both public requirements and Private needs are taken care of.

- **Balanced Economic Growth:**

- Mixedism Promotes balanced growth of the Economy.
- It promotes balanced growth between agriculture and industry, Consumer goods and capital goods, Rural and urban etc.

- **Proper Utilization of Resources:**

- In a mixed economy, the government can ensure proper utilization of resources.
- The government controls most of the Important activities directly and the Private sector indirectly.

- **Economic Equality:** The government uses progressive rates of taxation for Levying income tax to bring about Economic equality.

- **Special Advantages to the Society:** The government safeguards the interest of the workers and weaker sections by legislating on minimum wages, and rationing, establishing fair price Shops and formulating social welfare Measures.

Demerits of Mixed Economy:

- **Lack of Coordination:**
 - The greatest Drawback of mixedism is lack of Coordination between public sector and private sector.
 - As both work with Divergent motives, it creates many Coordination related problems.
- **Competitive Attitude:** It is expected that both government and private should work with a complementary Spirit towards the welfare of the society, but in reality, they are competitive in their activities.
- **Inefficiency:** Most of the public sectors Enterprises remain inefficient due to Lethargic bureaucracy, red tapism and Lack of motivation.
- **Fear of Nationalization:** In a mixed economy, the fear of nationalization discourages the private entrepreneurs in their business operations and Innovative initiatives.
- **Widening Inequality:**
 - Ownership Of resources, laws of inheritance and Profit motive of people widens the gap between rich and poor.
 - Ultimately the inequality of Capitalism and inefficiency of socialism are found in mixed economies.

Circular Flow of Income:

- The circular flow of income is a Model of an economy showing connections between different sectors of an economy.
- It shows flows of income, goods and Services and factors of production between economic agents such as firms, Households, government and nations.
- The circular flow analysis is the basis of national accounts and macroeconomics Circular Flow of Income.

Two-Sector Economy:

There are only two sectors namely, Household sector and firm sector.

- **Household Sector:**

- The household Sector is the sole buyer of goods and Services, and the sole supplier of Factors of production, i.e., land, labour, Capital and organisation.
- It spends its Entire income on the purchase of goods and services produced by the business Sector.
- The household sector receives Income from firm sector by providing the factors of production owned by it.

- **Firms:**

- The firm sector generates its Revenue by selling goods and services to the household sector.
- It hires the Factors of production, i.e., land, labour, Capital and organisation, owned by the Household sector.
- The firm sector sells the entire output to households.
- In a two-sector economy, production and sales are equal and there will be a Circular flow of income and goods.
- The Outer circle represents real flow (factors and goods) and the inner circle represents the monetary flow (factor prices and Commodity prices).
- Real flow indicates the factor services flow from household Sector to the business sector, and goods and services flow from business sector to the household.
- The basic identities of the Two-sector economy are as under:

$$Y = C + I$$

Y is Income; C is Consumption; I is Investment

- In addition to household and firms, inclusion of the government sector makes this model a three-sector model.
- The government levies taxes on households and firms, Purchases goods and services from firms, and receive factors of production from Household sector.

- On the other hand, the Government also makes social transfers Such as pension, relief, subsidies to the Households.
- Similarly, Government pays the firms for the purchases of goods and Services.
- The Flow Chart illustrates three-

Sector Economy model:

- Under three sector models, national Income (Y) is obtained by adding Consumption expenditure (C), Investment Expenditure (I) and Government Expenditure (G).

Therefore:

$$Y = C + I + G$$

- In a Four-sector economy, in addition to household, firms and government, a Fourth sector namely, external sector is Included.
- In real life, only four-sector Economy exists.
- This model is composed of four sectors namely,
 - (i) Households,
 - (ii) Firms,
 - (iii) Government,
 - (iv) External sector
- The external sector comprises Exports and imports.
- It is illustrated in the Flow Chart.
- In four-sector economy, expenditure for the entire economy include domestic Expenditure (C+I+G) and net exports (X- M).

Therefore:

$$Y = C + I + G + (X - M)$$