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**Paper: 12, Business Environment**

**Module: 03, Economic Systems**



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Items	Description of Module
<b>Subject Name</b>	Management
<b>Paper Name</b>	Business Environment
<b>Module Title</b>	Economic Systems
<b>Module Id</b>	Module no.-03
<b>Pre- Requisites</b>	Basic knowledge of Economic Environment
<b>Objectives</b>	To study the various types of economic systems in present scenerio
<b>Keywords</b>	Economic System, Capitalism, Socialism, Mixed Economy

## QUADRANT-I

1. Module 3: Economic Systems
2. Learning Outcome
3. Meaning and Definition of Economic System
4. Meaning, Features, Merits & Demerits of Capitalism
5. Meaning, Features, Merits & Demerits of Socialism
6. Meaning, Features, Merits & Demerits of Mixed Economy
7. Basis of Differences
8. Summary

### Learning Outcome:

After completing this module the students will be able to:

- Understand the concepts of Economic System
- Understand the features of different Economic Systems
- Describe the Pros and Cons of each Economic Systems

### 1. Introduction

Today all economies are facing with the same economic problem that of scarce resources and endless human wants. Therefore every society has to ensure the best use of their available limited resources. This decision is determined by answering three fundamental economic questions i.e.

**What to produce?** It deals with allocation of resources among alternatives i.e. to produce varieties of goods and services which yield greatest satisfaction to the consumers.

**How to produce?** This deals with utilizing the effective method of production to produce the goods and services.

**For whom to produce?** It deals with the equitable distribution of goods and services among all members in the economy.

Economic system is an important aspect of economic environment. The country's economic environment totally depends upon the type of economic system being followed as it influences the every economic decisions and policies related to economy. An economic system is a system that governs the economic decisions related to utilization of resources for the production, distribution, consumption and exchange of goods and services in an economy.

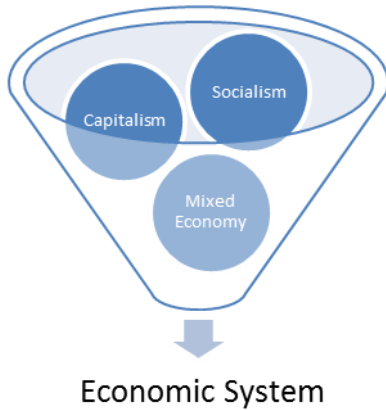
### 2. Definition of Economic System

Economic system refers to the framework concerned with the allocation of resources for the purpose of production and distribution of goods & services in a society/ country within the prescribed rules governing ownership and administration.

According to **Loucks**, "Economic system consists of those institutions which a given people or nation or group of nations has chosen or accepted as the means through which resources are utilized for the satisfaction of human wants.

1.1 In the words of **Gruchy**, “Economic system is an evolving pattern or complex of human relations which is concerned with the disposal of scarce resources for the purchase of satisfying various private and public needs for goods and services”.

### 3. Types of Economic System

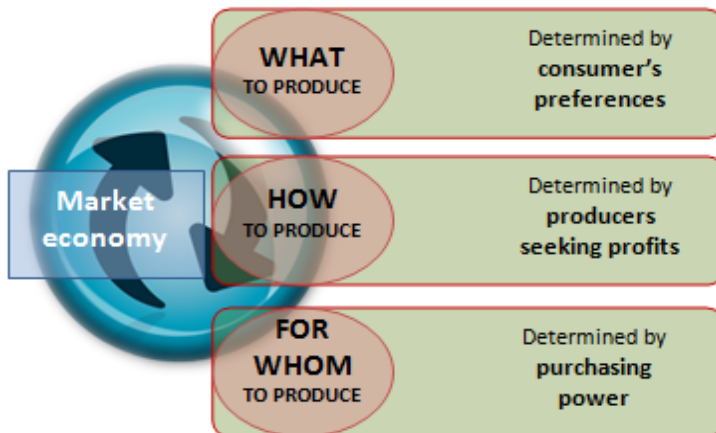


At present there are three important types of economic system i.e. Capitalism, Socialism and Mixed economy. These economic systems are **characterised** by the following:

- Role of government
- Freedom of choice
- Ownership of resources
- Price determination
- Who gains the profits earned

### 4. Capitalism

In the words of **G.D.H. Cole**, “Capitalism is a system of production for profit under which instruments and materials of production are privately owned and the work is done mainly by hired labour, the product belonging to the capitalist owner or owners.”



Adapted from: [http://www.economicsonline.co.uk/Competitive markets/Economic systems.html](http://www.economicsonline.co.uk/Competitive_markets/Economic_systems.html)

The capitalist or free enterprise economy is the oldest form of economy which supported the policy of ‘laissez fair’. Capitalism ensures minimum government intervention in the economic activities. Capitalist economies are also known as private enterprise economies in which all sources of production and distribution managed under the private ownership of individuals and institutions. The production of goods and services is based on supply and demand in the general market, rather than through central planning. Capitalism is generally characterized by competition between producers. In this economic system, the Government intervention is subjected to internal and external security of the country mainly perform activities related to ensuring justice to people, framing of law etc

## 4.1 Characteristics of Capitalism

The following are the main features of a capitalist economy:

- **Private property:** Under capitalism individuals are empowered with the freedom to own property and exercise control over the use of property. After the death of a person the property or wealth is transferred to the legal heirs as per the system of right of inheritance. All factors of production such as land, machines, mines, factories owned by private enterprises to earn profit and accumulate wealth.
- **Freedom of enterprise:** Business firms are free from any kind of government restriction to acquire and use of resources in the production and sale of goods or services of their choice. Every citizen has freedom to start any type of business with associated risk and can earn profit or loss according to prevalent condition in the business environment.
- **Consumer's Sovereignty:** In a capitalist economy consumer is treated like king. All the economic decisions related to production and distribution is guided by consumer's choice and preferences. Consumers enjoy the benefit of spending their income on those goods and services that give them maximum satisfaction and well suited as per their need and aspirations. This freedom of consumers is called consumer's sovereignty.
- **Profit Motive:** Under capitalism entrepreneurial activities are guided by profit motive. Entrepreneurs will own the profit or loss after making payment to all other factors of production. In order to maximise its profit entrepreneurs are always motivated to make investment in such projects that yields higher return with minimum cost.
- **Competition:** Competition is the prominent feature of capitalist economy that ensures the optimum use of factors of production and safeguard against consumer's exploitation. The presence of perfect competition ensures availability of products and services at competitive prices to the consumers and earning of normal profit by all firms.
- **Free market mechanism:** Free market mechanism is a system where the transactions are settled automatically by the market forces without having any interference of government and third party. The demand and supply forces determine the pricing of goods and services with which producer are able to earn normal profit.
- **Absence of government interference:** As discussed above in a free enterprise economy, all economic activities are guided by market forces and government intervention assumed to be nil for the purpose of smooth functioning of economy.

### Capitalism in today's world

Pure capitalism is not seen in the world now-a-days. The economies of USA, UK, France, Netherland, Spain, Portugal, Australia etc are known as capitalistic countries with active role of their respective government in economic development.

## 4.2 Merits of Capitalism

The positive points of capitalism discussed as follows:

- **Quality Products at Low Costs:** Due to presence of intense competition among producers or business enterprises, consumers are able to get variety of quality products at competitive prices.

- **Progress and Prosperity:** The capitalism encourages competition and innovation among producers that leads to the improvement in the method of production that brings efficiency and more profits needed for growth purpose.
- **Optimum use of Resources:** Under capitalism, producers undertake the production of goods which appear to yield maximum profits in anticipation of demand. This leads to optimum use of resources.
- **Flexible System:** Capitalist economy is a highly adaptable as it adjust itself according to changing economic conditions. The forces of demand and supply automatically adjust the situation of shortages or surpluses.
- **Economic Freedom:** Everybody enjoys economic freedom in capitalism. Producers have complete freedom to invest in any business or trade. Consumers can spend his income on goods and services according to his desire.
- **Variety of Goods and Services:** Every economic decision of what to produce, how to produce and for whom to produce are taken by producers taking into consideration consumers' taste and preferences. Therefore large variety of goods and services are produced in the economy.
- **Higher Standard of Living:** Supply of essential commodities to poor and weaker sections of society and availability of variety of goods and services as per customer needs and wants leads to rise in their standard of living.
- **Incentive to efficient:** In this type of economy, workers are fairly rewarded as per their productivity that brings efficiency among workers. Hence, workers try to work more and more leading to increase in total output.

### 4.3 Demerits of Capitalism

According to **Karl Marx**, "*Capitalism contains the seeds of its own destruction.*"

The arguments against capitalism are discussed as follows:

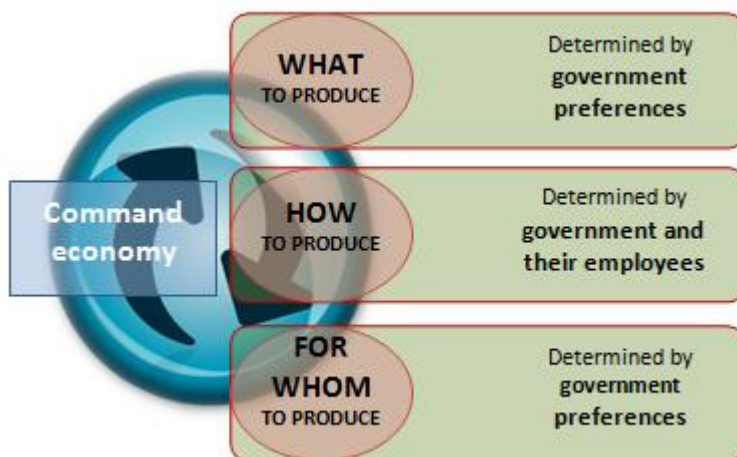
- **Inequalities:** Under capitalism producers attempt to produce luxurious items which are demanded by rich section of the society and remain less focused on production of essential commodities demanded by weaker/poor sections. So there may be a situation of shortage of essential goods that leads to increase in prices of commodities that ultimately brings more profit to producers. As a result of this, gap between have and have not widen further.
- **Consumers' Sovereignty a Myth:** Due to absence of government intervention in every economic decision governing production, distribution and consumption of goods, producers are in a position to exploit resources as well as customers for their own benefit by creating artificial shortage of goods, presenting misleading advertisements about the usefulness of the products etc. Thus there is no consumers' sovereignty in a seller's market.
- **Economic Fluctuations:** Capitalism is characterised by free market mechanism that assume market forces brings stability in economy but if such circumstances arises under which market forces fail to cope up in accordance with the requirement then as a result of this nation may fall in deep economic crisis or may collapse the whole economic system.
- **Defective utilisation of Resources:** Capitalism fails to produce goods keeping in view the society's requirements. Resources are being wasted on the production of luxurious goods to

satisfy the demand of few rich at the expense of ignoring the needs of lower section lead to misallocation of resources.

- **Class Conflict:** As discussed earlier, gap between rich and poor widen under capitalism. Rich segment of society can exploit the poor section as they want due to lack of government intervention may lead to class conflict which can adversely affect law and order situation with in country.
- **Wasteful Competition:** Excess competition is wasteful competition as there is no restriction / barrier in entry or exit of firm in the market. Huge financial resources spend by firms on advertisement and other sales promotion techniques in order to lure customers for buying products. The cost of such expenses borne by the customers in the form of increased prices.
- **Unbalanced Growth:** Under capitalism central planning authority has no role to ensure balance economic development in a country and due to the economic freedom enjoy by business enterprises, the investment will be high in that area where profitability is high. The priority sector areas where potential profitability is low will be neglected by private entrepreneurs and will remain underdeveloped as the government support is minimum in this economic system.
- **No Welfare Activities:** In capitalism economic decisions of entities are governed by their self interest which is profit motive not by social welfare.

## 2. Socialism / Planned / Command Economic System

According to *Samuelson*, “the important essentials of socialism are that all the great industries and the land should be publicly or collectively owned and that they should be conducted for the common good instead of private profit.”



Adapted from: [http://www.economicsonline.co.uk/Competitive\\_markets/Economic\\_systems.html](http://www.economicsonline.co.uk/Competitive_markets/Economic_systems.html)

Central meaning of socialism is **common ownership**. Planned economy supports the philosophy of ‘Equity’ by equal distribution of income. Under this system, all the productive resources are owned, acquired, managed and controlled by the government with the objective of providing benefit to society. Under socialism, every economic activity is guided by the policy of social welfare as there is no room for personal interest. The anti social activities like smuggling and hoarding find no place in socialism. Socialist economy based on the system in which state owned the all means of production with the motive to produce goods and services as per needs of society. Socialism is diametrically opposite to capitalism where goods and services are produced to generate profit without any social welfare objective.

## 5.1 Characteristics of Socialism

The socialist economy has the following main features:

- **Collective Ownership of means of Production:** The ownership of resources of production, distribution and exchange lies with the government. No individual is allowed to have private property, accumulate wealth and run any business. Government direct the allocation of resources, exercise control over private wealth and production unit and ensure equitable distribution of income in an economy.
- **Social Welfare Objective:** The government has control over means of production and utilized the earned profit for the benefit of society at large. The market forces do not play any role. Every economic decision is taken keeping in mind welfare objectives.
- **Central Planning:** Socialism is characterized by central planning. Central planning authority in the light of available resources and national priorities of planned growth allocates the resources. Planning authority fixes growth targets for every sector that ensure optimum utilization of resources.
- **Reduction in Inequalities:** Equitable distribution of income is ensured in socialism. Equal chances are given to all in all the fields like occupation, education etc. Every individual enjoys equal opportunity irrespective of religion, caste, creed etc.
- **Administered prices:** Under socialism free market mechanism is absent only Government is authorised for determining prices of goods and services. Administered price benefit to poor section of society by charging subsidized price from them. On the other hand by charging higher price from rich section government ensure equity within economy.

### Socialism in today's world

Countries such as People's Republic of China, Communist Party of Vietnam, Democratic Socialist Republic of Sri Lanka, Portuguese Republic, United Republic of Tanzania, Republic of Cuba are said to be Socialist countries.

## 5.2 Merits of Socialist Economy

The merits of socialist economy are as follows:

- **Full employment:** Central planning authority operates for achieving socio-economic objectives such as poverty alleviation, full employment, increase in national and per capita income etc. Socialism ensures attaining full employment by utilizing productive resources according to national plan and priorities.
- **Proper Utilisation of Resources:** Socialism ensures optimum utilization of resources. Central planning authority after assessing the basic needs of people, exploit the resources in best possible manner.
- **No Cyclical Fluctuations:** During depression no investment will come from private sector but socialism ensure effective control over cyclical fluctuation as the government pumped up investment in an economy that generate employment & income which create demand for goods and services. So by taking suitable timely action government can easily handle the crisis.
- **Social Welfare:** Social justice is the prime feature of planned economy as all wealth and resources owned by government. Socialism ensure equal opportunity to all in the society without any discrimination.

- **Rapid Economic Development:** All economic activities are guided by central plan that channelizes the effort of every individual or enterprise toward achievement of national objectives that put the country on the path of progress and prosperity.
- **Most Suitable to Developing Countries:** This type of economic system is most suitable to the needs of developing countries as all means of production are controlled by the government.

### 5.3 Demerits of Socialist Economy

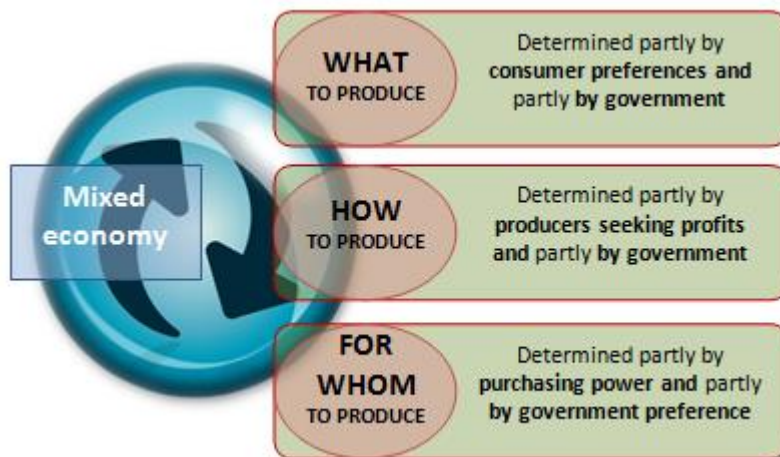
The main limitation of socialist economies discussed as follows:

- **Loss of Consumer Sovereignty:** Consumers have no freedom to choose goods and services as per their desire. They have to consume those goods which are produce and available as per central plan of government.
- **Less Democratic:** In Socialism, there is state monopoly and complete absence of individual freedom. All resources are managed by government so there is no provision for accumulate wealth and personal profits that criticize this system.
- **No Automatic Functioning:** There is no automatic functioning under socialism as the central planning authority governed the economic activities according to its own interest.
- **Evils of Bureaucracy:** socialism encourages evils of bureaucracy like corruption, red-tapism as the power for making decision vested with government officials. Personal interests of corrupt government officials are served at the cost of the nation.
- **Rigid Economy:** Socialist economy is very rigid in nature as it doesn't make changes in their policies according to changes in external environment. There is no scope of any kind of economic reforms under such rigid system.
- **Burden on Government:** No doubt government has entitled with monopoly in socialism but the negative aspect of this approach is that central authority is overburdened with the routine matters and remains with less time to think and plan for economic prosperity of the country.
- **Expenditure on Planning:** In fact, planning is a long process in a socialist economy. This expenditure is unnecessarily wasteful and a burden on the national economy.
- **Elimination of Individualism:** There is no provision to owned private property by individual, absence of consumer freedom and choice and absence of free enterprises in socialism. Complete absence of freedom is ethically wrong and all these factors can create anti-state agitation that can cause political instability in the country.
- **Non-existence of Competition:** Fair competition brings economic prosperity to a nation. Absence of competition among producers leads to inefficiencies and decreased productivity.

## 6. Mixed Economy

According to **J.W.Grove**, *“One of the pre- suppositions of a mixed economy is that private firms are less free to control major decisions about production and consumption than they would be under capitalist- free enterprise, and that public industry is free from government restraints than it would be under centrally directed socialist enterprise”*.





Adapted from: [http://www.economicsonline.co.uk/Competitive\\_markets/Economic\\_systems.html](http://www.economicsonline.co.uk/Competitive_markets/Economic_systems.html)

Mixed economy is a perfect blend of two extremely opposite economic system. Mixed Economy is an economic system that possesses the characteristics of both capitalism and socialism. This economic system is governed by selective/limited government intervention and also allows individual freedom with in limit framed by government. Private investment is also encouraged subject to the areas reserved for public sector. Mixed economic system permits the private sector to run business and earn profits but if such enterprise deemed to go against the interest of society then such enterprise can be nationalize by government in order to exercise complete control over it.

### 6.1 Characteristics of Mixed Economy

Mixed economy possesses the merits of both capitalism and socialism as discussed below:

- **Co-existence of public and private sector:** Under mixed economy, the public and private sector participate jointly for the development of country. The resources of country owned and used by both government and private industrialists. Public sector enterprises also earn profits like private industries which are utilised for capital formation. Private sector operates as per regulations of government in the interest of society. Public and private sector expected to work on cooperative basis but in certain fields of production, both operate in competitive spirit that is also in the interest of society.
- **Economic Planning:** Centralized planning authority laid down various targets and objectives in the plan for the growth of economy. The government framed various policies from time to time such as monetary, fiscal and industrial policy etc. in order to achieve above targets with in specified period.
- **Dual price mechanism:** Mixed economy is governed by both market mechanism and government directives administrative. Forces of demand and supply determined the prices of goods and services produced by private sector but in case of public sector pricing of goods and services done by Government.
- **Freedom and Control:** Mixed economy ensures the individual freedom regarding production, distribution and exchange of goods and services. Individuals can own property and can have any occupation under the selective and effective government intervention.
- **Dual objectives:** Social welfare and profit motive go side by side as both public and private sector earned profit under mixed economy. Public sector operates with the motive of social welfare such as providing employment and offering social security benefits to support poor section. Taxes are levied on the profit earned by private sector in order to prevent concentration of economic power and resources in the hands of big corporate houses.

- *All developing countries like **India** are mixed economies.*

## 6.2 Merits of Mixed Economy

The merits of mixed economy discussed as follows:

- **Best Allocation of Resources:** The prominent features of Mixed economy such as individual freedom, dual price mechanism and presence of competition between public and private sector leads to the efficient utilization of resources.
- **General Balance:** As mentioned earlier, mixed system posses the positive points of capitalism and socialism that ensure maintenance of general balance between public and private sector. Public sector remained focussed on availability of basic infrastructural facilities and direct the private investment as per targets laid down in the central plan.
- **Adequate Freedom and control:** Mixed economy permits adequate freedom to different economic units. Consumers are free to dispose their incomes in a manner they want, although government try to influence consumer decisions through monetary and fiscal policies, (b) Factors of production are free to choose their own occupations and the Government strive to create conditions favourable for the growth of chosen occupations, (c) Entrepreneurship is always encouraged.
- **Rapid economic development:** Public ownership of the means of production is indispensable for economic growth and social justice. No doubt, state plays a vital role for economic development but it also seeks the co-operation of the private sector which possesses adequate resources, expertise and experience. Thus in the underdeveloped economies, the mixed economic pattern accelerates economic development.

## 6.3 Demerits of Mixed Economy

A mixed economy has also certain defects which are discussed below:

- **Non-Cooperation between the Two Sectors:** Under mixed economy the private sector is taxed heavily and various restrictions imposed upon it by the state, while the public sector procure subsidized inputs, such a discrimination develop the sense of non-cooperation between the two sectors.
- **Fear of Nationalisation:** Government monitors the profit level of private enterprises. The fear of Government policy to nationalise private enterprises is likely to prevail in mixed economy.
- **Low inflow of Foreign Capital:** As discussed above due to government nationalisation policy, there is less scope for inflow of foreign investment which is essential for economic development of country.
- **Delay in Economic Decisions:** In a mixed economy, there is always delay in making certain decisions, especially in case of public sector. This type of delay always leads to a great hindrance in the path of smooth functioning of the economy.
- **Corruption and Black Marketing:** There is always corruption and black marketing in this system. Political parties and self- interested people take undue advantages from public sector. Hence, this leads to emergence of several evils like black money, bribe, tax evasion and other illegal activities. All these ultimately bring red-tapism within the system.

### 7. Difference between Planned, Capitalism and Mixed Economy

Characteristics	Planned Economy	Capitalism	Mixed Economy
<b>Role of Government</b>	Decides all economic activities	Little or no role of Govt.	Govt. creates laws and regulates business activities
<b>Freedom of Choice</b>	No Freedom of Choice	Consumers and producers have freedom of Choice	Limited freedom of Choice given Govt. controls
<b>Ownership of Natural resources</b>	State / Public sector	Private Sector	Both public and private sector
<b>Price Determination</b>	Govt. sets price	Price mechanism system determines price	Price mechanism system but regulated by government
<b>Which Sector answers the basic economic questions?</b>	State / Public sector	Private Sector	Both public and private sector

**Summary:** Every country follows different economic system. The economic system of a country may be: Capitalism which is characterized by the ‘laissez faire’ policy that stresses upon the philosophy of profit maximization, private ownership of property, consumer sovereignty and limited role of Government. Socialism or Centrally Planned Economies emphasizes the philosophy of equitable distribution of income, social welfare, full employment and administered prices. Mixed economy is a compromise between two extremely different economic systems that ensures co-existence of public and private sector, flexibility, centralized economic planning, individual freedom, social welfare as well as profit motive. Every economic system has positive as well as negative aspects. Practically, the suitability of a particular economic system that a country follows depends upon the historical background of the people, the extent of wealth or natural resources of a country will of political parties etc.

