

Chapter 17

ECONOMIC SYSTEMS

Introduction

The pattern of economic institutions and organisations in various countries is not the same. There is difference in the economic relations of different groups of people and also, the strategies to solve basic economic problems of the society are not the same.

The term economic system refers to the whole structure of economic institutions and the pattern of their working through which the resources of a country are allocated and the way economic relationships between different groups of people are determined; how consumers and producers carry on their activities and what role the government plays in economic matters. Economic system is also called economy.¹

There are three basic economic problems, which every human society has to solve. These are

- what to produce
- How to produce
- For whom to produce

What to produce means what commodities and in what quantities a country should produce. Should a country use its resources to produce more agricultural goods or industrial goods and more consumer goods or capital goods like machinery?

How to produce refers to the methods of production and the kind of technology to be used for producing goods. One particular commodity can be produced in different ways. For example, a road can be built by using more human labour or more machinery.

For whom to produce means the distribution of national income. Everybody cannot get equal share of income. Some get more and become rich while others get less and remain poor. How this distribution occurs and what are arrangements through which various groups of people get rewarded for their work?

These problems do not have only one solution. Alternative ways, or rather alternative systems, exist in this regard.

¹ The word economy in fact, has two meanings. Consider the following sentences, (i) 'American economy is capitalistic'. Here economy means economic system (ii) 'Pakistan's economy is developing'. Here economy means sum total of all kind of economic activities in the form of production in industry, agriculture, business, services, money, banking etc.

If we have a look around the world from the point of view of an economist, we find that although in every country economic conditions are different, yet they can be grouped into a few broad categories or economic systems under which they solve their basic, problems of 'how', 'what' and 'for whom'. Every economic system has some peculiar features, which distinguish it from others. These systems have been named as:

- (i) Capitalism
- (ii) Socialism
- (iii) Mixed Economy
- (iv) Islamic Economic System

In the following pages, we look into the working of each system in some detail.

CAPITALISM (Free market system)

Capitalism is the economic system based on the principle of private ownership and use of factors of production and individual freedom in all economic matters.² Under this system, all farms, factories, transport and others means of production are the property of individuals and firms. They are free to use them anyway they like and earn income. There is freedom in all spheres of economic activity, e.g., freedom of occupation and freedom of contract. The government has a minimum role in this system. Capitalism is sometimes called free enterprise system or market economy.

SALIENT FEATURES

1. **Right of Private Property** Under capitalism, people have the right to own private property, including means of production. They can possess houses, cars, farms, factories and money. They have also the right to pass on their property to their heirs. They can use their property for any business and get profit.

2. **Economic Freedom** Capitalistic system ensures freedom in productive activities. This freedom has three parts (i) freedom of enterprise (ii) freedom of contract and (iii) freedom to use one's property. A person can set up any business, can establish any firm and can choose any occupation. He may work or may remain idle. He can employ other persons or get employment himself on the terms and conditions agreed mutually.

However, the freedom of enterprise is not absolute. Some restrictions are put by the government to protect the rights of other people. For example, if a transporter wants to put the passengers on the top of the bus, he may not be allowed.

3. **Freedom of Choice for the Consumers** People enjoy the freedom of choice to demand and consume anything. They can spend their incomes as they like. Under capitalism a consumer is sovereign. It is the consumers who finally decide what is to be produced. If the consumers are willing to pay a higher price for a commodity, it will be

² The system is called capitalism because under this system, the more a person owns capital, the more powerful he becomes in influencing the working of the economy.

produced more. Since producers work for profit, they cannot produce a commodity which is not wanted by the consumers.

4. **Profit Motive and Self Interest** The capitalistic system works under profit motive. The producers produce that commodity and use that method of production in which they find higher profits. Similarly, workers select that job where wages are higher. Consumers are interested to buy a commodity at the lowest possible price. Thus, everybody acts in his self interest and not for some social service.

5. **Importance of Price Mechanism** Capitalism is governed by prices. Everybody, whether producer or consumer, gets guidance from the prices in the market. For example, if the price of a commodity is rising in the market, it is a signal for the producer to produce more. If wages (or which is the same thing as price of labour) rise in a certain line of business, job seekers will be attracted to that. Consumers' purchase plan is determined in the light of relative prices of various goods. e.g., if price of rice falls relative to that of wheat, they consume more rice. So, it is the price mechanism which guides, controls and regulates the different economic activities. Adam Smith had termed this mechanism as 'invisible hand'.

6. **Competition** In capitalism, there is competition in all spheres of life. Since everybody looks to his own personal interest, he competes with others. A producer competes with other producers to sell his product. A worker competes with other workers to get a job. And a consumer competes with other consumers to get the commodity of his choice. There is an unending struggle for existence and to excel others.

Along with competition, an opposite tendency is also visible, i.e., people cooperate for their self interest. So firms may unite to get some concession from the government or to raise the prices. Mostly this happens because the competition is not perfect. Thus, workers unite and form labour unions. The doctors, traders, mill owners and bus owners have their 'associations'.³

7. **Economic Inequalities and Class Conflict** Under capitalism, economic inequalities arise. Since people have freedom, some get the chance to earn higher profits, higher wages or higher returns for use of their property. Inequalities in incomes and wealth go on increasing. Some people come to own more capital while many cannot find a job even. This gives rise to two classes of 'haves' and 'have-nots', which come into conflict with each other, e.g., the workers think that the factory owners are not paying them enough wages, while the factory owners complain that the workers do not work whole heartedly.

8. **No Coordination** The system works automatically without any conscious coordination by government or some other organisation. Millions of producers work independently. Workers, engaged in various activities, can not cooperate and consumers buy goods without consulting other consumers. Due to absence of coordination, sometimes there is over production while at some other times there is shortage.⁴

³ Daily, public transport wagons are competing out their rivals through all legal or illegal means. But someday, we find they have all united and gone on strike to get some common benefit.

⁴ Many examples can be cited of problems created due to lack of coordination. In one locality too many private schools may be opened while in the other locality, there may be too few. On one route, too many buses may be plying, while on the other too few. Similarly, it may happen that too much potato may come to market

MERITS

Capitalism has the following merits.

1. **Automatic Working** Capitalism works automatically without any direction or control by a central planning authority. If at some time, a disturbance occurs somewhere, it automatically gets corrected through changes in prices. Suppose in some year, production of potatoes falls short of existing demand. Now, how demand and supply will get equal? It will so happen that price of potatoes will rise. At higher price of potatoes, people will start consuming more of some other vegetables and will reduce their demand for potatoes. On the other hand, growers of other commodities will be attracted to grow and supply more potatoes. Thus, equilibrium in the market will be reached without using any force. (Similarly, if more people become doctors than needed, their wages will fall. Then fewer new persons will come to this field).
2. **Optimum Utilization of Resources** In order to maximize their profits, every producer and entrepreneur tries to use the productive resources at his disposal in the most economical way. People try to avoid waste and the owners of resources do not want to keep them idle or under utilized. For example, the owner of a house will try that his house should never remain vacant. A factory owner will never like to unnecessarily close his factory and a worker will not like that he remains out of work. Thus, self-interest under capitalism ensures optimum use of resources. Minimum time is wasted. For example, if a private bus has some trouble, the owner tries to get it repaired at the earliest while if that is some government vehicle, it may remain in the workshop for weeks.
3. **Incentive for Hard Work and Higher Efficiency** Under capitalism, since more efficient producers get higher profit and more expert workers receive higher returns, people try to work hard and improve their efficiency. They are induced to use latest machinery, learn new technology and get further training to increase their earning capacity. A private producer wants to produce a good or service within minimum time, with less material and at least cost. Now a day, everybody is trying to learn and use computers in his business since computers increase efficiency.
4. **Rapid Economic Development** Due to right of private property, people are induced to save a part of their incomes and invest it. This increases the rate of capital formation. And because no human or material resources remain unnecessarily idle, rate of economic development remains high. The entrepreneurs in order to earn profits take risk. They innovate and accelerate the improvement in technology.
5. **Democratic** There is freedom to produce or to consume anything. There is no interference by the government in consumer's choice and the selection of professions. Since the tastes and choice of millions of consumers form the basis of the working of the system, it is democratic in nature.
6. **Adaptability** Due to complete freedom, existence of competition and premaxy of self interest, the rule, 'survival of the fittest' applies in this system. As

growers have produced without knowing what others are doing. Thus, too much quantity of potatoes bring the price so low that all growers suffer losses.

conditions change, everybody tries to adapt to the new situation as early as possible. Thus, this system has a remarkable capacity for adaptability to new circumstances.

The free market responds quickly to people's wants

DEMERITS

Capitalism has many drawbacks as discussed below.

1. **Concentration of Wealth and Economic Power** Due to freedom of enterprise on the one hand, and absence of perfect competition on the other, monopolies start emerging and national resources get concentrated in fewer hands. Big business controls the market and small producers are eliminated. Prices are then raised and consumers are exploited. Those who have already huge amounts of wealth, get more chances of earning higher incomes.
2. **Wasteful Competition** Instead of perfect competition, imperfect competition with all its shortcomings exists in capitalism. In such a situation, huge resources are wasted on advertisement and publicity to eliminate the rivals. The resources of those who lose in this race also go waste. Too many varieties are produced, which are not only wasteful but also raise per unit cost of products.
3. **Human Welfare Ignored** Since goods are produced for profit and since profits are greater in production of those goods which are used by rich people, the entrepreneurs are more interested in production of luxuries than goods used by common man. In this way, general human welfare is neglected.
4. **Exploitation** Under capitalism, due to absence of restrictions, all kinds of exploitation continues. Labour is exploited by giving them lower wages, consumers are exploited by providing them inferior quality goods at higher prices, and weaker sections of society are exploited by denying them opportunities for a reasonable life. Due to abundance of wealth, some people buy goods in too much quantity of goods that nothing is left for the poor.
5. **Malpractices** In order to increase profits, all kinds of malpractices are resorted to. Tax is evaded. Hoarding and speculation continue in the name of trade. Black money is used to live a luxurious life at the cost of national interest.
6. **Economic Instability and Unemployment** Capitalism does not work smoothly. Frequent ups and downs occur in economic activity. Since there is no coordination among producers, sometimes there is over production of goods in the market. Stocks accumulate. As a result, the producers reduce their output, which results in unemployment.
7. **Social Injustice and Income Inequalities** On the one side, few rich capitalists enjoy all kinds of luxuries while on the other, millions of wage earners live in poverty, struggling for minimum necessities of life. There is great inequality in opportunities for various groups of people. This situation gives rise to class conflict. The poorer sections think that the root cause of their miseries are the capitalists.

8. **Incentive to Work may Suffer.** Under pure capitalism, the gap between the rich and the poor may become too much. Then, on the one hand, the poor lose their incentive for hard work since they find no hope of improvement in their condition and on the other side, the rich have less incentive for struggle because they already enjoy a lot.

SOCIALISM

The idea of socialism was developed by Karl Marx in 19th century. It was put forward as a reaction to the evils of capitalism. The idea was especially welcomed by working classes. In 1917, Russia adopted socialism and soon it spread to cover a large part of the world. During past few years people have got disappointed with the poor performance of this system and have abandoned it in its original form. However, in the meanwhile many characteristics of socialism have been adopted in capitalistic countries giving them a new form as mixed economies. Now mixed economies are the fashion of the day.

MEANING

Socialism does not have a common meaning. Different people include different things in it. However, the basic thinking is the same, i.e., the government should have control over economic activities, and private ownership of land and capital be either abolished or put under tight restrictions. Thus, we can say that,

Socialism is a system under which all capital and natural resources are owned by the state and all production is centrally planned as if the whole economy is one big firm.

Dickenson defines it as,

Socialism is an economic organisation of society, in which the material means of production are owned by the whole community and operated by organs, representative of, and responsible to the community, according to a general plan; all members of the community being entitled to have equal benefit from the resulting production.

FEATURES

Socialism has the following features

1. **State Ownership of Means of Production** Under this system, private ownership of means of production is abolished and lands, factories, mines, etc. are collectively owned. The profit goes to the government treasury which is used for the benefit of the whole society. Sometimes, instead of direct control, cooperative societies are formed.
2. **No Private Enterprise** All production is under state control and private individuals have no right to establish a business of their own.
3. **Economic Equality** Socialism lays much stress on economic equality. All means of production are used for collective interest of the people. In the absence of earning opportunities, except as a government employee, inequalities of income and wealth remain within narrow limits. Since system of inheritance is not there, accumulation of wealth does not take place.

4. **Equal Opportunities** Socialism provides equality of opportunity. Every young person has the same opportunity to receive education and training according to his aptitude and strive to rise in life.

5. **Economic Planning** Economic planning is must for socialism. When means of production are under the control of the government, they have to be utilized according to a plan so that only those goods are produced which are needed by the people. For this purpose, a central planning authority is set up. The authority determines the objectives and priorities for national output. Then it allocates the resources according to the set priorities. For example, after taking into consideration all cultivable land in the country, it is the planning authority which will decide how much land is to be used for wheat growing and how much for rice.

6. **Social Welfare and Social Security** The guiding force behind socialism is social welfare and not the profit motive. State prepares all plans for the benefit of the whole community and not for a few rich. In a socialist state, it is the duty of the government to provide social security to every person and to arrange for his education, health and recreation. The government also ensures job security. There is no concept of unemployment in socialism.

7. **Classless Society** Socialism strikes at the root of class system. There is no landlord or tenant and no capitalist or labourer. The gap between the rich and the poor is narrow and it is not hereditary. The children of today's highly paid persons may be poor tomorrow, if they can not compete with others through education and hard work.

MERITS

1. **Social Justice** Socialism brings social justice and equitable distribution of income. Exploitation of weaker sections of society is stopped and same economic opportunities exist for all. Everybody can find a place in life according to his aptitude, education, struggle and mental and physical faculties.

2. **Better Allocation of Resources** Productive resources are used in the best interest of the nation. Because of absence of monopolies and vested interests, only those goods are produced which have maximum benefit for the largest number of people. A good balance is maintained between consumers' preferences and social welfare. Production of luxuries is discouraged.

3. **Rapid Economic Development** In the initial stages of development, when a country is poor, through state control of economic activities, pace of economic development can be accelerated. This is what happened in Russia, China etc. Under socialism, human and material resources are used according to a plan. Rates of savings and investments are kept high. Since profit is no consideration, basic industries producing machinery and capital goods are given preference. The overall standard of living may be lower, but there is security of income and job.

4. **Social Security** It is a great merit of socialism that everybody is assured of food, basic education, medical care and job. These are the problems which make the life of a poor man miserable under capitalism.

5. Economic Stability Socialism brings economic stability. Unlike capitalism, where fluctuations in prices, incomes and employment level occur regularly in the form of a business cycle, economic conditions under socialism remain stable. There is no fear of over production, unemployment or inflation.

DEMERITS

1. Loss of Economic Freedom Everybody has a natural love for freedom of action. This is a strong objection against socialism that people have no freedom. They cannot set up a business of their choice. Jobs are allotted according to the scheme of the planning authority. A person may be unsatisfied with his job but can not easily shift to some other occupation. But freedom is such a charming thing that people like to accept a lower standard of living provided there is freedom.

2. Loss of Consumer's Sovereignty Under socialism, the quantities of various goods to be produced are decided by the central planning authority. Consumer's choice is given less preference. So the consumer loses freedom of choice. This fact decreases people's welfare and satisfaction. A person who likes brown shoes, if offered black ones, cannot feel satisfied.

3. Lack of Incentives Self-interest is a natural instinct which is a motive force in capitalism. A person puts his best efforts only if he feels that the fruits of his labour will come to him. But under socialism, people are expected to work for common cause and social welfare. So they do not find much interest in the job. The result is that their productivity is very low.

4. Economic Equality Not Achieved A basic slogan of socialism is economic equality. But experience has shown that socialism fails to bring equality. The difference between the rich and the poor continues and the goal of classless society is not achieved. Only new classes emerge. In place of conflict between capitalists and labourers, a new kind of conflict and inequality appears i.e. between powerful factory managers and workers or between bureaucrats and lower office workers.

5. State too Powerful There is too much concentration of power in state. And when absolute political and economic power is held by the state, individuals are reduced to cipher. Due to loss of personal liberty, there is degradation of human personality and his capabilities deteriorate. Under too many controls and limited opportunities, even a dynamic personality becomes a dull and routine worker.

6. Maladjustment in Demand and Supply Since no indicator exists in the form of price, the changes in demand and supply are not noticed in time. So there is chronic maladjustment in demand of commodities and their supply. The central planning authority tries to adjust supply to demand but due to fixed prices in the market, it is difficult to know what changes have taken place in consumers' preferences.

7. Bureaucracy and Red Tapism In all spheres, bureaucratic attitude is developed. Duties are performed as a routine. There is excessive bossism. Prompt decisions are not taken, so there is all round inefficiency. The civil servants are actually unsuitable for business decisions. The condition and considerations are quite different in