

## Topic 1.2

# Resource Allocation and Economic Systems

*"Choosing where to live, what to do, even which clothes to put on in the morning is tough enough for those of us accustomed to making choices; it can be utterly paralyzing for people who've had decisions made for them by the state their entire lives."*

—Barbara Demick, *Nothing to Envy: Ordinary Lives in North Korea* (2009)

**Essential Question:** How do different economic systems allocate resources?

**H**ow would you run the economy of your household, your community, or your country if you could? Would you divide up all resources equally, so everyone gets the same? Maybe you would give more resources to people who needed more, people who worked harder, or people who did something to please you.

An **economic system** is defined by the way a society answers three questions:

- *What* goods and services will be produced?
- *How* will those goods and services be produced?
- *Who* will consume the goods and services?

The economic system where you live helps to shape your entire life. In one type of system, you might know from an early age that you would do the same type of work your parents and grandparents had done. In another type of system, the government might assign you a career based on how well you did in school or what economic planners thought the economy needed to prosper. In still another, you might be able to choose your own career—if others valued your goods or services enough to pay you a wage that you found acceptable.

In each system, someone or something different also controls the **means of production**. This term refers to everything used to supply goods and services, such as farmland, copper mines, factories, office buildings, robots, and supercomputers. The owners of the means of production control much of a society's economy.

## Types of Economic Systems

To economists, another question that helps define the different types of economic systems is: *Who or what answers the three questions?* There are a few different types of economic systems, and in each, someone or something different answers this question and the three questions above.

**Traditional Economy** In a **traditional economy**, what has happened in the past answers the three questions. Traditional economies are almost exclusively tied to communities of subsistence farmers and herders. Cultural traditions linked to family and/or tribal units determine what crops are grown or what animals are raised, what farming or herding methods are employed, and how the resources produced are utilized and shared. In this type of economy, the means of production are controlled by the community. Traditional economies are increasingly rare in the modern world.

**Command Economy** In a **command economy**, a central authority answers the questions. Command economies, also known as planned economies, are often an outgrowth of a socialist or communist government. In these systems, the central government devises and implements a plan for what goods and services will be produced, how they will be produced, and who will consume the goods and services. In a command economy, the means of production are controlled by the state rather than individuals or private companies. As a result, entrepreneurship is rare. Advocates for command economies argue that they can provide more equitable distribution of goods and services and greater efficiency in using resources. As with traditional economies, pure command economies have become increasingly rare.

**Market Economy** In a **market economy** (also called a capitalist economy), neither tradition nor the state control most economic decisions. Individuals and firms answer the three questions. Far from being discouraged or rare, private property and entrepreneurship are the backbone of a market economy. Individuals and firms have great freedom to produce whatever they like and in whatever manner they see fit. Consumers are free to purchase a wide range of goods and services they want and are able to. Producers try to maximize their profit, and consumers try to acquire the things they want at the best possible price. The market system is broadly considered to be the most efficient economic system.

**Mixed Economy** Today, every country in the world engages in what is known as a **mixed economy**. Most countries are mainly capitalist, allowing individuals and businesses to act in their own interests, for the most part. However, state involvement also plays a key role through actions such as safety regulations, minimum wage mandates, environmental laws, business development incentives, and many others.

The following chart sums up some of the differences between the various economic systems.

## TYPES OF ECONOMIC SYSTEMS

Key Questions	Traditional Economy	Command Economy	Market Economy (Capitalism)	Mixed Economy
What is it?	A system in which long-standing cultural customs and societal structures determine the economy	A system in which government planners decide what will be produced and who will receive it	A system in which buyers and sellers decide what a society's economic priorities will be	A system with features of both a market economy and a command economy
Who owns the means of production?	The community	The government	Businesses and individuals	Mostly businesses and individuals, but with differing levels of government regulation
What are some examples as of 2020?	The reindeer-herding Sami people of Scandinavia engage in a traditional economy. But no countries have an exclusively traditional economy.	North Korea, Cuba, and Belarus were mostly command economies.	The United States, the United Kingdom, Singapore, and Botswana were mostly market economies.	All countries are mixed economies, but each has its own mixture, where different systems are represented to a greater or lesser degree.

### Resource Allocation in Different Economic Systems

A society's economic system strongly influences resource allocation. Every society that has ever existed has had scarce resources, and decisions about who controls the resources and how people use them are usually controversial. What follows is a more in-depth look at the functioning of command, market, and mixed economic systems at work in the modern world.

**Resource Allocation in Command Economies** For much of the 20th century, large-scale command economies existed in the former Soviet Union, China, and elsewhere. During World War II, the United States became more of a command economy as the government regulated economic activity in order to support the military. Since the late 20th century, many economies have become more market-oriented. Market economies and command economies were once considered to be opposites, but today most command economies include some degree of market-based planning. This planning involves several basic questions:

- **What goods and services do people produce?** People produce the goods and services that the government believes are necessary to produce. They do so not to make a profit, but to best serve the country's needs as articulated by the government and its leaders. The government often tightly regulates who can start a business.
- **How do people produce those goods and services?** Central planners who work for the government set economic goals for the country as a whole. They decide where factories and other workplaces will be located, who will do what work, and how much people will be paid.
- **Who consumes those goods and services?** The government decides how much people will earn and what material goods they will be able to buy. Governments might claim to treat all citizens equally. However, in large-scale command economies such as the old Soviet Union, a small group of government leaders, scientists, and top athletes received better housing and far more luxuries than the average person had access to.

**Resource Allocation in Market Economies** Market economies have existed since the 1600s, as the feudal system (in which most people worked for a local lord or other large landowner) began declining. Today most people live in market economies, but all have some degree of government regulation:

- **What goods and services do people produce?** Market economies provide a vast and sometimes bewildering array of goods and services. Individuals and businesses develop, test, and produce what they believe consumers will demand—whether that is a self-driving car or a phone app that lets the user pretend to pop bubble wrap. If the market rejects a good or service, then its creator loses money.  
How much people and organizations charge for goods and services depends on their competitors—others who sell identical or similar products. If you are an entrepreneur who produces a desired good or service and you have no competitors, then you can charge a high price. However, if you make high profits, other businesses or individuals will enter the market and put downward pressure on the prices you charge.
- **How do people produce those goods and services?** If you live in a market economy, innovation and technology are likely to be all around you. The career that you succeed in may not have existed in your parents' time. In fact, it may not even have been invented yet. Market economies are much larger than traditional economies, and their large populations of consumers often generate huge amounts of trash and pollution. Balancing environmental needs with consumers' desire for innovation is one of the challenges of a market economy, as individuals, businesses, and governments consider constraints and trade-offs.
- **Who consumes those goods and services?** What people consume reflects what they can afford to purchase. Individuals with more resources can consume more, while individuals with fewer resources consume less.



Source: DuKai/Getty Images

China was overwhelmingly a command economy in the 1950s through the 1980s. In the 1990s, China began adding free-market elements to its economy, following the advice of its leader Deng Xiaoping to "let some people get rich first." As a result, cities such as Shanghai (shown above) quickly became very wealthy, while rural areas were slower to escape poverty.

## Control of Scarce Resources in Economic Systems

Every economic system involves constraints and trade-offs as people and institutions struggle for control of resources. Furthermore, each system makes decisions about the allocation of scarce resources through key institutions, or well-established organizations. Key institutions in a market economy are private businesses, including both large corporations and small enterprises run by individuals or families. In addition, local, state, and national governments are important in organizing and regulating the activities of private businesses.

Each system has coordinating mechanisms, or organizations and technologies through which natural resources reach companies and goods and services reach customers. For example, suppose you are a manager of a company that manufactures bicycles. Think of all the pieces and parts that go into making bikes: pedals, tires, gears, handlebars, and so forth. Your company could make each part, but you are likely to be more efficient if you buy pieces from various specialized manufacturers. Your company coordinates the process of getting all the parts together, assembling the bicycles, and shipping them to stores. All these activities are known as coordinating mechanisms. Resources are treated differently under different economic systems.

**Human Resources** People who create goods and services (also called human resources or labor) receive different treatment depending on the economic system they are in:

- Traditional economies value workers who can carry on the skills and crafts of their ancestors. Family and community are the key institutions.
- Command economies might support research and innovation sponsored by the government, but they often criticize individual entrepreneurs for being more focused on making money for themselves than on serving the public.

- Market economies value entrepreneurship—being able to combine human resources, natural resources, and capital resources in a way that succeeds in the marketplace.

**Natural Resources** Materials that the planet provides and that humans use (also called land) are essential to every economic system. In every system, individuals and companies must employ coordinating mechanisms to gather natural resources and supply them to the people who use them to create products:

- Traditional economies use individuals and communities to gain access to natural resources. They place the least burden on natural resources because these societies are small and do not innovate as often as other economies do.
- Many command economies, such as China's, are also industrialized. But in a command economy, government is the controlling institution, making decisions about the kinds of products and services that the country will produce.
- Many market economies are highly industrialized. That is, they use technological processes to turn raw materials into finished products. Market economies use natural resources heavily as producers and consumers continually seek lower-cost, newer, and more desirable products.

Sometimes poor use of natural resources causes the same problems in market economies and command economies. For instance, ill-advised farming methods caused massive dust storms in the United States in the 1930s and in China in the 2010s.

**Capital Resources** Tools and machines are part of every economic system, and factories and offices are part of most economic systems. Again here, in different systems these resources are treated differently:

- People in traditional economies value the tools and machines their ancestors used, such as fishing nets and sleds.
- In command economies, the government owns capital resources.
- In market economies, individuals and private groups own most capital resources.

#### ANSWER THE TOPIC ESSENTIAL QUESTION

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1. In one to three paragraphs, explain the three main economic systems and how they allocate resources.