

Types of Economic Systems

Everything you need to know about the types of economic systems. Economic system determines the nature of state intervention in the business.

Thus, economic system is an integral part of the business environment. Economic System consists of “those institutions which a given people, a nation or a group of nations have chosen or accepted as the means through which their resources are to be utilized for the satisfaction of the human wants.”

The three types of economic systems are:-

1. Capitalism
2. Socialism
3. Mixed Economic System.

3 Types of Economic Systems:

Capitalism, Socialism and Mixed Economic System

Types of Economic Systems – Capitalism, Socialism and Mixed Economic System (With Features, Merits, Demerits and Comparison)

1. Capitalism:

Capitalism is an economic system which can be identified from private ownership on the means of production and profit motivated production relations. In the literature, it is also named as free market economic system or a laissez-faire capitalism. In such an economic system, each economic entity whether individuals or companies, own and distribute resources or goods in a way so as to maximize their respective financial gains.

According to Macmillan Dictionary of Modern Economics, capitalism is defined as a social and economic system in which capital assets are mainly owned and controlled by private persons, labour is purchased for money wages, capital gains accrue to private owners, and the price mechanism is utilized to allocate capital goods between uses.

Features of Capitalism:

Following are the important features of capitalism:

i. Economic Freedom:

Economic freedom, as a basic feature of capitalism, has two major constituents, freedom of choice and freedom of enterprises.

a. Freedom of Choice:

It means that all economic entities, such as consumers, producers and workers, in the economy are free to make their own economic decisions, in the backdrop of resource scarcity, with regard to the resources they own. To a consumer, it means freedom to spend income on whichever goods and services he may desire.

b. Freedom of Enterprises:

A freedom of enterprises means freedom to a producer to own and operate any business. As an owner of a business organization, an individual is free to make any business decision.

Given the economic freedom, price mechanism plays an important role in the economy according to which a rational individual will exercise his rights in the best self-interest aimed at profit maximization or satisfaction maximization.

ii. Private Ownership:

In a capitalist setup, all the factors of production, as also goods and services, are privately owned. Such an ownership entitles the owners to use the resources in a manner in which they are comfortable with. Obviously, being rational owners, they will deploy the resources so as to get maximum rewards or earnings.

The right of private ownership will facilitate accumulation of wealth by all the economic entities which, in turn, will push the economic growth at aggregate.

iii. Right of Inheritance:

The inheritance means transfer from one generation to next generation. In the context of capitalism, it means transfer of assets from father to offspring. The capitalism provide right of inheritance to all individuals which act as an incentive to accumulate more wealth. It implies more economic activities and more income generation in a capitalist economy.

iv. Profit Motive:

In the capitalist economy, every activity will be governed by profit consideration. A producer will strive for maximum profit, a consumer for maximum satisfaction and a factor for maximum reward. Obviously, resources will be deployed only in those areas which are capable of providing maximum return or profit, given their scarcity.

v. Competitive Market:

All the capitalist economics are required to have competitive markets in which numerous sellers offer their goods and services to numerous buyers. This will ensure that each seller will make only a normal profit. Likewise, factor markets are also competitive which means that each factor will provide its services to a producer who offers a maximum rewards. Such competitive markets will be self-regulatory through the invisible hands of price mechanism.

This will encourage firms to always strive for better products and services for a larger market share or profit. A factor will also strive for higher productivity for better rewards as factor payments. Thus, each economic entity will attempt to improve all the time which, in turn, will push the entire economy up and up.

vi. Price Mechanism:

The price mechanism in a capitalist set up acts as a coordinating mechanism. It determines price of each and every economic activity. It works through demand and supply forces to determine equilibrium price.

vii. No Government Intervention:

The capitalist system does not involve any government interventions. Economic decisions are taken freely on the basis of price mechanism.

Merits of Capitalism:

i. Promote Economic Growth:

Many economist have argued that capitalism have great ability to promote economic growth. It leads to a faster GDP growth and better capacity utilization.

ii. High Living Standards and Hard Work:

The capitalism, while ensuring rapid economic growth, also facilitates a high living standard for all the consumers, each one of which is paid according to their respective contribution in production process. Thus, it encourages factors to strive for higher productivity and work hard so as to be rewarded better. With higher income, they will have higher living standard. The common capitalist mantra is that anyone can be rich if they work hard enough.

iii. Promote Technological Progress:

Given the intense market competition, rate of technological innovation will be high as each firm will attempt to grab market. In other words, capitalism will promote innovation and improvement in production techniques which may either contribute in lowering cost of production or improve product quality. In the quest of profit, each firm will try to offer products better than competitors. Thus, successful innovations will strengthen the competitive strength of a firm in a capitalist setup.

iv. Stimulate Rate of Capital Formation:

Two of its features, viz., private ownership and law of inheritance, encourages everyone to own more and more properties, physical as well as intellectual, and pass it on the next generation after their death. Such a tendency will stimulate the rate of capital formation in the economy.

v. Optimum Resource Utilization:

Since all the markets in a capitalist economy are competitive, it promotes efficient and optimum resource utilization at each level.

Further, the interplay of market forces ensures resource to be deployed in most productive uses. In brief, thus, capitalism encourages optimum resource utilization.

vi. Emergence of Entrepreneurship:

Given the prevalence of profit prospects in the market, whosoever may have potential and capabilities will emerge as entrepreneur. Hence, there will be addition of new entrepreneurs all the time.

vii. Benefit of Automatic Functioning:

The capitalism has a unique advantage of automatic functioning of the economy. All the economic decisions are based on price mechanism. It, in other words, it means that cost of decision making at each level is nil.

viii. Sovereignty of Consumers:

Consumer in a capitalist society is accorded a status of king. It means that all the economic decisions revolve around the consumer. His decision making regarding what to consume and how much will significantly influence the firms' survival and growth.

Demerits of Capitalism:

i. Income Inequality:

It is not true that anyone can be rich if they work hard enough. In fact, one will grow under capitalism at the cost of others only. It means that along with every rich, a large army of poor will coexist. In simple terms, there will be a growing income inequality in a capitalistic setup.

In fact, it is this demerit of capitalism that has been amply highlighted by the socialist thinkers including Karl Marx. It has provided a basis for the evolution of socialist form of economic system, as an alternative to capitalism.

ii. Economic Instability:

The free market mechanism of a capitalist society is a source of cyclic behaviour of the economy, commonly known as trade cycle or business cycle. Such behaviour of economy will produce recession and inflation in the economy one after other and, hence give rise to instability in growth.

Both of it will not be good for the economy. A recessionary phase will result into unemployment causing considerable hardship to the workers who will be thrown out of their jobs for none of their mistake. Likewise, an upward economic swing will strengthen inflation again adversely affecting the poor in the economy.

iii. Social Welfare is Ignored:

Another important demerit of the capitalism is that it does not bother about social welfare. For example, in the process of allocating resources across products, more allocation is made for luxury goods rather than basic necessities. It is because of the fact that the profit prospects are much better in the production of luxury items as compared to basic necessities.

iv. A Lot of Wasteful Expenditure:

In capitalism, intense market competition force companies to go for large selling cost though which aggressive sale-promotion is carried out. Such expenditure is wasteful in nature since it does not add any value to the products for the consumer. It may simply help companies to protect their respective market share from competitors. In fact, capitalism is known for a cut-throat competition implying that such wasteful expenditure is huge.

Another source of wasteful expenditure comes from unequal income distribution in a capitalist society. While the rich usually do a lot of wasteful expenditure, poor do not find enough to meet even basic necessities and hence starve.

v. Exploitation:

It is not correct to say that a capitalist economy pays everyone as per their contribution to the production process. The marginal productivity theory of distribution, tells that every worker is paid a sum equals to marginal productivity of last unit of labour and not that of his own. The difference between the own marginal productivity and that of the last unit is basically the profit of the producer or exploitation of the worker.

vi. Emergence of Monopoly Market:

Under capitalist society, each firm wants to become bigger and bigger. They even adopt strategies to throw out competitors out of market to grab the market share. Obviously, competitive markets will gradually become oligopolistic or even monopolist in long run. A monopolist firm produces a lower quantity and charges a higher price than that of a competitive firm.

Further, in long run, a competitive firm will only earn a normal profit while a monopolist will always earn a super normal profit. Again, a monopolist will not mind to sell the same product at different prices to different customers through price discrimination while a competitive firm will not be capable of doing so.

Based on all these facts, one can say that the under capitalism the monopolies will emerge and exploit the workers and consumers enormously and impoverish the majority of the population as the monopolists want to maximize their super normal profits.

vii. Undemocratic in Nature:

While it is claim that capitalism is democratic in nature, this is not true. Rich and powerful, both individuals and companies, usually have more say in government policy-making as compared to the poor.

Criticism:

It is not surprising therefore that the capitalism has been severely criticized by a large number of social scientists including economists and sociologist, for all the demerits inbuilt in it. So much so that the capitalism have been completely discarded by the socialist thinkers. They have propagated altogether a new form of economic system which is based on equality and social justice. It is known as socialism.

2. Socialism:

Emergence of socialism has been traced above in the criticisms of capitalism, specifically the rising income inequality under it which divides the society into have and have-nots. Further, the root cause of income inequality in capitalism is the private ownership on factors of production.

The socialist thinkers have, thus, proposed a socialist mode of product as an alternative to capitalism or as a solution to all the demerits of capitalism. To be precise, socialism proposes state ownership on means of production and maximum social benefits as profit motive in the production system. The system is looked upon as need-based rather than profit-based.

Important features of socialism can be highlighted as follows:

Salient Features of Socialism:

i. Social Ownership on Production Factors:

The basic feature of a socialist economy is that all major means of production are placed under collective social ownership rather than under the individual ownership. It thus takeover private property and transforms them into social property through nationalization. In simple words, all big industries and land are to be bought under state ownership. As a matter of fact, private ownership is considered at par with private robbery under socialism.

Practically speaking, however, only key and strategic means of production are brought under public ownership while some minor activities are left for individual ownership. Such private activities constitute an insignificant portion of the total activities in the economy.

ii. Motive of Social Welfare:

The socialism is fully dedicated to social welfare and the individual interests take a back seat. That is, individual interests are being sacrificed for social interests. The social interests are always supreme and maximizing social gains is the guiding motive of production. Basic philosophy is that entire society should be enriched rather than enriching a few.

iii. Economic Decisions and Planning:

Under socialism power to take economic decisions rest with public authorities and not with the profit-seeking private individuals and firms. The economic development is carried out through economic planning, which is an essential feature of socialism. Decisions regarding central problems (what, how and for whom to produce)

are taken by a central board or planning commission. It follows need-based decision-making in place of a profit-based one.

A need-based decision-making system is one which assured everyone a share in national income irrespective of his/her contribution in it. Given that decisions are taken through a planning process and not through market forces, such economies are also called as centrally planned economies.

iv. No Role of Price Mechanism and Lack of Market Competition:

Given the pre-dominant role of planning process, market oriented decision making through price mechanism has no role to play. As a result, there is no market competition, no rivalry between production units and, hence, no wastage of resources in the form of selling cost or sale promotion measures like . The State commands a virtual monopoly on production system.

v. Classless Society and No Exploitation:

Capitalist mode of production divides society into have and have-nots. Contrary to it, socialism attempts to create a classless society, a society of peasants and workers. Means of production being state-owned, there is no capitalist class.

Even if it existed, as under liberal socialism, it is effectively regulated and controlled by the state institutions. It has to operate within the framework provided by the State. It has to follow the regulation imposed on it. Obviously, such a system has no scope of exploitation.

In nutshell, the root cause of exploitation, the individual ownership on means of production, is being rooted out to a significant extent.

vi. Inequality in Income and Wealth Distribution:

Another important feature of the socialism is that income and wealth inequalities are within the pre-determined limits since it is a need-based rather than productivity-based system. Thus, there is no scope for social tension and no risk of disintegration.

vii. Social Security:

It provides social security to all implying that every member of the society is assured of an income, which is sufficient for satisfying his needs irrespective of the fact whether he is able to work or not. It

even takes care of old age needs of the people when they are unable to make contribution in production.

Merits of Socialism:

There are many advantages in socialism.

They can be summarized as follow:

i. Efficient Resource Utilization:

In a socialist economy, production decisions are taken by a central body on the basis of requirements of the economy. Depending upon the availability of resources, it decides to produce the items most needed and in just quantity ruling out any duplication of production. Hence, there is neither any wastage of resources nor unemployment. On this basis, one can argue that a socialist set up ensures efficient resource utilization.

ii. Inequality of Income within Desirable Limits or Distributive Justice:

Since factors of productions are owned by the government and the factor payments are need based, there is no possibility of income inequality beyond desirable limits. Moreover, it also offered social security to everyone, at least with regard to basic needs. In nutshell, it upholds the principles of distributive justice.

iii. No Class Struggle:

As the society does not divide into have and have-nots, there is no possibility for social tension and, hence, no scope for class struggle.

iv. No Economic Instability:

Since market mechanism has no role to play, presence of business cycles are not witnessed and hence no economic instability under socialism. Each and every sector develops in a planned manner. There is no excess demand or excess supply scenario. It implies that resources are better allocated under socialist mode of production.

v. No Unemployment:

In socialist mode of economic system, production is planned as per the availability of resources and, hence, there is no scope for unemployment.

De-Merits of Socialism:

i. Efficiency and Factor Productivities are Low:

Being a need based system it ignores efficiency and factor productivity. No serious attention is given, especially at individual level, to increase productivity since factor payments are no way linked to their respective contributions in the production.

Moreover, high social security also discourages a person to work hard as he knows that even if he does work, or does not work hard, his future is secured at least for basic needs. Further, even if he works harder, he will not gain much in terms of better life style. His needs are pre-determined by the system. As such labour productivity in socialism is always low.

At the other end, the production system is managed by state officials who have no personal interest in it and hence, has no incentives to perform.

For all these reasons, the socialism witness low labour productivity which may even decline overtime. The efficiency level is also found to be low in such a system.

ii. De-Motivating Hard Work:

An important weakness of socialism was that it adversely affected the motivation to work hard as no personal gains and losses are involved. This ultimately resulted in slower economic growth and smaller income generation.

iii. Complex Administration:

Since every venture and each aspect is managed by bureaucrats, the administrative process becomes very complex and the network becomes multi-layered. The state officials used to consider production system just as an extension of government departments. Thus, often it used to take a long time to take a decision which has to be approved at various levels. This not only increases the cost but often cause considerable delay in decision-making.

iv. No Consumer Sovereignty:

A serious drawback of the socialist system is that it has no respect for the consumer sovereignty. His preferences for the goods and services to be consumed have just no place in the decision making. He has to consume whatever decided for him by the State authorities. This considerably lowers his motivation to work.

v. No Economic Freedom:

In this form of economic system, there is neither a freedom of choice nor a freedom of enterprise, as observed in case of capitalism. Hence, workers have no job satisfaction. They are asked to perform a task and one has to do it whether he likes or dis-likes.

vi. Concentration of Power:

It has also been argued that the socialist system is also not free from concentration of power. Under it, power gradually concentrates in the hands of bureaucracy and the State machinery.

Criticism of Socialism:

Despite many merits and positive features of socialism, it has been criticized for several reasons, which are amply elaborated under its demerits. With the demise of socialism, it appears that its demerits were more powerful and its merits did not exist in reality.

3. Mixed Economic System:

A mixed economy is nothing but an attempt to incorporate advantages of both capitalism and socialism under it while keeping their respective disadvantages away.

Conceptually speaking, two forms of mixed economy can be identified:

- i. Mixed capitalist economy, and
- ii. Mixed socialist economy

i. Mixed Capitalist Economy:

A mixed capitalist economic system is one that rely more on capitalism while incorporating a few features of socialism into it. It is basically a market economy characterized by the presence of a small public sector to protect the welfare, especially of the weaker sections of the society. The presence of public sector is also noticeable in the areas such as, national security. The market mechanism plays a dominant role under it and government interventions in the market are limited.

As a matter of fact, almost all the capitalist economies of the world, now-a-days, are the mixed capitalist economies marked by the presence of a public sector and wide-ranging government interventions for orderly functioning of the respective economies.

The policy perception provided by Keynes following the great depression of the thirties laid the emergence of such mixed capitalist economies.

ii. Mixed Socialist Economy:

On the other hand, a mixed socialist economy will look more like a socialist economy marked by:

i. Some freedom to producers to operate mostly in non-core areas of production. Even the limited freedom to private sector is subjected to considerable government interventions through various macro-economic policies. This is to ensure that it functions in accordance with national development priorities.

ii. Considerable freedom to consumer to select goods and services for consumption, and

iii. Almost a complete freedom to factors of production, labour in particular, to choose the work place. The state influence resource deployment indirectly through different policy instruments.

Nonetheless, the State keeps an effective control over the economy and different markets are regulated to varying extent for their orderly functioning.

The two forms of mixed economic systems, thus, differ considerably with each other depending upon their leaning towards capitalism or socialism.

India's Economic System:

India is one of the countries that have experimented with a mixed socialist economic system since 1951. It instituted a physical control regime up until 1984. Towards this —

i. It established an industrial licensing regime, a rigid foreign exchange regulation regime, several price and distribution controls, and so on.

ii. It also setup several public sector undertakings and a distribution network consisting of numerous ration-shops.

iii. The state acted as a biggest employer in the economy providing employment to millions of youth.

iv. The financial sector, including the commercial banks, has functioned totally under RBI regulations and controls.

Despite all these and numerous other initiatives, the country suffered from slow growth, industrial stagnation, rising unemployment and high cost production structure.

This led policy makers to do a rethinking on policy regime and paved the way for economic liberalization since 1985 under which the country move away from the principles of socialism. Since 1991, it initiated an aggressive reform process under which role of market forces was gradually widened, areas reserved for public sector were considerably curtailed and more and more areas were opened up for private initiatives. In nutshell, India has made a gradual move from a mixed socialist economy to a mixed capitalist economy. Such a process of transformation is still continuing.

Features of a Mixed Economy:

Important features of a mixed economic system, keeping Indian economy in view, are highlighted below:

1. Public and Private Sectors:

A basic feature of mixed economic system is the co-existence of both public and private sectors under it. Mostly, essential and core production activities are placed under public sector while private sector is allowed to operate in non-core areas, such as production of consumables.

In India for example, production of heavy machinery and most of the critical intermediates, like petroleum products, fertilizers, chemicals, iron & steel etc., were put under the State ownership while private entrepreneurs were allowed to take up production of items like farming, textiles, leather items, and so on.

The Industrial policy-1991 has however, introduced a radical shift in the policy perception. It curtailed the scope for public sector by way of reducing areas reserved for it from 17 to just 4. Many public sector units were gradually privatized. The industrial licensing was virtually abolished which was a very powerful instrument for regulating private initiatives in industrialization in pre-1991 era.

All these and many other measures have significantly curtailed the scope for public sector and widened the scope for private sector. Still, even today Indian economy can be characterized by the presence of both public and private sectors.

2. Economic Welfare:

Under a mixed economic system, the Government introduces several instruments to safe-guard the interests of weaker and unorganized segments of the economy. For example,

- i. Regional balance may be taken into account while approving investment in different areas even though it lead to high production cost due to logistic disadvantages.
- ii. Similarly, for the sake of more employment opportunities a relatively out-dated and less efficient technology may be selected in place of a modern one.
- iii. In the field of distribution, essential items, like food grains, vegetable oil, sugar, salt etc. may be provided at a cheaper rate from public distribution system.

3. Economic Planning:

A mixed socialist economy considerably relies upon the planning process since the Government has to carry out almost all the critical production activities. For this purpose, in addition to a central planning board, the State and district level planning machinery is also established.

However, the role played by such a network of planning agencies is considerably less in a mixed capitalist economy. In a way, planning process will transform itself from a lead role to a supportive role in development process when an economy moves from mixed socialist to a mixed capitalist arrangement, as happened in the case of India in post-1991 era.

4. Profit Motivation:

Economic activities guided by profit motivation are limited in a mixed socialist economy but are considerable under a mixed capitalist economy. Even the role market mechanism is different under the two modes of production, more in a mixed capitalist economy and less in the other.

5. Private Ownership:

Both the forms of mixed economic system allow private ownership on means of production though in the socialist setup they may be

subjected to regulations for a more equitable distribution of such ownerships. For example, in India, rich are subjected to wealth tax so that capital accumulation in a few hands may be restricted, to an extent.

Likewise, earlier an Estate duty was also in force which was abolished in the reform process. Further, there are land-ceiling Acts, applicable to both rural and urban areas. Such regulations in a mixed capitalist setup are fewer in number and less severe.

6. Freedom of Choice:

Similarly, the two types of mixed economic systems also provide for freedom of choice to all means of production but this may not be unlimited in case of the socialist one.

7. Income Inequality:

Given that market mechanism is in force, possibility of rising income inequality cannot be ruled out. However, under an inclination towards socialism, the government through various policy instruments attempts to keep it within a desired limit. For example, high personal incomes are subjected to higher income tax under progressive taxation or luxury goods are imposed high excise duty. On the other hand, income of the workers may be protected through Minimum Wage Acts. Subsidies may be provided to the necessity goods.

Merits of Mixed Economic System:

Being an attempt to bring positive aspects of the capitalism and the socialism both, the mixed system is marked by several advantages. They are highlighted below as merits of mixed economic system.

1. Faster Economic Development:

Given that the mixed economic system provides a role to both public and private sectors, it ensures a faster and balanced growth.

2. Limited Income Inequality:

Further, the mixed economic system ensures income inequality to remain within a desired limit since the Governments apply various policy instruments to control it.

3. Equal Opportunities to All:

The mixed economic setup provides opportunities to grow to all. For example, in India, it has provided reservation to the backward castes in jobs for facilitating their uplifting.

Likewise, it has exclusively reserved certain sectors for small scale and tiny units. The large companies are not allowed to venture in those areas. However, post-1991, areas under such reservations is curtailed considerably.

At the same time, planning process also ensure development of all the geographical pockets of the country by way of making a balance in investment allocation.

4. Scope for Private Initiatives:

The mixed economic systems being marked by the co-existence of both public and private sectors, provides ample scope for private growth initiatives. It is, however, somewhat more in case of mixed capitalist system than that in mixed socialist system.

It is very much evident from the Indian example. The post-reform era has widened the scope for private sector considerably not only by way of opening newer areas for it but also by way of reducing restrictions on its operations. For example, The MRTP Commission and FERA regulations were abolished and replaced by a Competition commission and FEMA regulations respectively. They are far less restrictive on growth of private sector.

5. Ensure Social Justice:

Governments under mixed economic systems, enact various legislations to protect the interests of backward sectors which save them from market exploitation. This ensures growth with social justice. For example, Indian government provides considerable support, financial or otherwise, to backward classes. It also runs numerous schemes for the benefits of poor or low income population.

6. Freedom of Choice and Consumer's Sovereignty:

Despite restrictions, consumers in a mixed economy enjoy a considerable sovereignty as the consumables are mostly governed by market mechanism. At the same time, government ensures availability of essential items to all at reasonable prices. Workers are allowed freedom to choose the place of work. The system, however, imposes some restrictions on big companies in the national interests.

7. Economic Stability:

In a mixed economy, government being the biggest market player allows economy to oscillate within a desirable limit. In case of high

inflation or recession, policy interventions and direct actions may be introduced by the government.

Further, even the private sector may be asked to operate within the broader policy framework to limit the economic instability. Hence, the mixed economic system ensures economic stability to a considerable extent and, at the same, leave ample scope for market forces.

Demerits of Mixed Economic System:

1. Slower Economic Growth:

Theoretically, a mixed economic system is expected to achieve a faster growth. However, India in reality has witnessed not only a slower economic growth but industrial stagnation as well under its socialist setup. In contrast, the post 1991 era, which is marked by closeness to capitalism, has witnessed a higher growth. This indicates that the mixed socialist system may not be favourable to the economic growth.

2. No Efficient Use of Resources:

In a mixed system, efficient use of resources may not be promoted all the time. The investment in public sector may suffer from economic irrationality and hence less productive. On the other hand, private sector may suffocate due to excessive regulations. In totality, such a system may lead to inefficient use of resources.

3. Too much Government Intervention:

This is a universal tendency in all the mixed economic setups that the governments continue to make rules and regulations for every problem faced by the economy. Too much government intervention will defeat the purpose for which the mixed economic system was setup.

4. Disadvantage of Capitalism and Socialism:

While the conceptualization of mixed economy is aimed at to incorporate merits of both capitalism and socialism into it, in practice it appears that it has incorporated demerits of the both the systems.