**Chapter 2.4 – Central Economic Problems III – Three Types of Economic Systems**

**2.4.1 Meaning and Functions of Economic System**

To conduct resource allocation, there is a need of an economic system to perform the task to resolve the three fundamental economic problems on what and the amount of goods and services, how the goods and services are to be produced and for whom the goods and services are to be produced for. In our modern civilization, there are three prominent economic systems and they are namely:

a) Free market system (capitalist economy of free enterprise economy)

b)      Centrally planned economy/command economy

c)       Mixed economy

**Three types of economic system vary due to these grounds:**

a)      The ownership of resources (factors of production)

The economic system will differ in terms of resource ownership which will determine who will be owning the resources and how it is to be used.

b)      The mechanisms for resources allocation

The economic system will differ in terms of the approach on how the economic activities will be conducted to conduct the process of resource allocation

c)       the values of the economic systems

The economic system will differ in terms of the values that guide the way how the economic activities will be conducted.

**2.4.2 Free Market Economy**

I. Meaning

In this type of economic system, the resources in the economy are privately owned and the economic activities are organised by the private entity which will promote free enterprise and free choice of consumption. The value that guides the economy is self-interest.   In this economic system, the mechanism adopted is termed as the price mechanism which relies on market forces of demand and supply.

**II. Advantages and Disadvantages**

**Strengths of the Free Market Economy**

* Provides incentive for greater effort as it rewards the individuals
* Swift adjustment of resources allocation – reduce the cost of resource allocation

**Weaknesses of the Free Market Economy**

* May contribute to market failures – welfare loss to the society
* May lead to unequal distribution of income and resources

**2.4.3 Command Economy**

**I. Meaning**

In this type of economic system, the resources are owned by the state and will be decided by the state on how they are to be used. Decision making on economic activities are decided by the government which will determine the ways resources are allocated. The economy is guided by collective interest for the society.

**II. Advantages and Disadvantages**

Strengths of the Command Economy

* Can adjust resources to the need of the state
* Can avoid uneven distribution of resources

Weaknesses of the Command Economy

* No inducement for effort and investment
* Experience time lag in the implementation of policies

**2.4.4 Mixed Economy**

I. Meaning

In this type of economy, the resources in the economy are both owned by the state and the individuals. Decision-making on economic activities can be made by the state and the enterprises and the economy is guided by self-interest and the interests of the society. The degree of its mix in the economic system depends on the level of government and enterprise participation.

**II. Advantages and Disadvantages**

Strengths of the Mixed Economy

* Reap the benefit of the operations of the market forces and government regulations
* Provide the impetus for individual to excel and at the same time, can eliminate the undesirable effects of income inequalities.
* Combine the benefit of competition and cooperation
* Strive to meet the needs of the individuals and society
* May achieve short and long term aims of the government
* Consumers’ interest is guarded while the private sector can strive for greater growth and development.

Weaknesses of the Mixed Economy

* Difficult to reconcile the interest of the states and the society
* Difficult to draw a clear line on the scope of areas for the private sector and government sector to operate
* Inherent economic problems in the country may undermine the directions of the economic development
* Problems encountered during the transition of the economy towards market reforms

III. Problems encountered during the transition from command to mixed economy.

**1)** **Lack of understanding of the function of the price mechanism**

Price was previously set by the government - may not understand the price changes may be temporary and excessive production will occur or may not respond to price changes quick enough to lead to shortages – absence of business knowledge – may have excessive consumer exploitation – failure to proliferate information on price system.

**2)** **Lack of entrepreneurship**

No experience in guiding economic activities – may lead to wastage and inefficient method of production – poor skills in collecting information, decision-making, managing resources and price setting

**3)** **Absence of infrastructure and institutional support**

The economy may not have the adequate facilities that will help the economy to introduce market reform – eg business registration bodies or coordinating bodies or infrastructure to help the businesses build up external economies of scale to reap greater efficiency.

**4)** **Rise of corruption and other forms of unfair political power to corrupt the function of fair and efficient market reform.**

**5)** **Unable to deal with the extensive economic fluctuation that may occur due to change in the decision-making system**

**6)** **The society may not be able to adapt to the reform of self-dependency**

Lesser welfare blanket to take care of the people – social inequality and unequal distribution of resources will occur – creates greater social unrest and instability.

**7)** **Obsolete machineries**

Meaning low productivity to compete in global market – may not be able to compete well with other economies