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THE DIFFERENT TYPES OF ECONOMY

All economies face the same problems: **WHAT, HOW** and **FOR WHOM** to produce.

But there are different approaches to solve them: **free market economy** and **planned economy** are perhaps the most famous, but in reality we can find only few examples all over the world of these extremes types of economy, most being at some intermediate point between these extremes.

In a **FREE MARKET** (or PRIVATE ENTERPRISE) **ECONOMY** all the factors of production are owned by private individuals and the decisions of **WHAT, HOW** and **FOR WHOM** are made unconsciously by the interaction of the market forces.

“ It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love{...}. Every individual necessarily labours to render the annual revenue of the society as great as he can. He generally neither intends to promote the public interest, nor knows how much he is promoting it{...}. He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention”

(From "An Inquiry into the Nature and Causes of the Wealth of Nations" Adam Smith, 1776).

Perhaps nowadays it's hard to agree with these words of Adam Smith, often regarded as the father of economics, but they describe very well the so-called mechanism of “the invisible hand”.

We must assume that consumers are rational and always attempt to maximise the utility they receive from their incomes, and that entrepreneur are also rational and always attempt to maximise their profits.

The system in which the invisible hand is most often assumed to work is the free market. Adam Smith assumed that consumers generally choose the alternative with the lowest price, and that entrepreneurs choose the alternative offering the highest rate of profit. He asserted that by thus making their excess or insufficient demand known through market prices, consumers "directed" entrepreneurs' investment money to the most profitable industry: so, in general, economic well-being is increased. One

extremely positive aspect of a market-based economy is that it forces people to think about what other people want.

Consumers are free to purchase whatever they wish in the market place. This is sometimes expressed as “consumer votes” in the sense that they will spend more of their incomes (votes) on goods they favour. As the demand of these goods increases, their price will rise, making them more profitable, and entrepreneurs seeking greater profit will respond by entering into the production of these goods, thereby increasing their supply.

Production is therefore said to respond to “price signals” which indicate those goods which should be produced, and “consumer sovereignty” prevails over the market.

The technical problem of “**how to produce**” is determined by competition between producers, which forces them to adopt the *least cost method* of production.

The problem of “**for whom**”, the problem of distribution, is determined by relative incomes, which in turn are determined by supply and demand. If labour is scarce relative to its demand, then wages will be higher and a greater proportion of output will go to wage earners; the same is true of owners of land and capital.

The concept of “*consumer votes*” should not be equated with any concept of “fairness” in the accepted sense: in fact some people have far more “votes” than others, and if this is seen as a problem, then it is one of income distribution not the price mechanism in itself.

Exercise n.1

The mechanism of the “invisible hand”

Put in the correct order the following sentences

(as they are now)

1. Consumers will spend more of their incomes on goods they favour.
2. The demand of these goods increases.
3. The price of these goods will rise.
4. The production of these goods become more profitable.
5. The entrepreneurs will enter into the production of these goods.
6. The supply of these goods will increase.
7. Production is therefore said to respond to “price signals”.

The **PLANNED** (or **COMMAND**) **ECONOMY** is characterised by the collective ownership of the means of production and hence the *price mechanism* does not operate. The decisions of **what, how** and **for whom** are made by a central planning body who make their decisions in view of what they perceive as the needs of society.

The **MIXED ECONOMY** is characteristic of most modern economies and while leaving much production in private hands it allows for a substantial role for the government in the production of certain goods and services and controls the worst excesses (i.e. the duplication of plant) of the market place. To some extent it attempts to combine the better aspects of both the previous systems. Today the concept of the mixed economy is generally accepted although there may be disagreement over the extent of the government's role. During the last few decades, at times the government that have prevailed are those (Conservative, right oriented) who have made attempts to reduce the role of the state in the economy by "*privatising*" some sectors of production and reducing the amount of intervention elsewhere. Other times those who have prevailed are the ones (Labour, left oriented) who wanted to increase the role of the state by "*nationalising*" some companies. "Nationalisation" especially occurs to provide those essential goods and services which would not be adequately provided by the free market: in particular those referred to as "*merit goods*" such as education and health, or pure public goods such as defence. Other main reasons for the involvement of the government in the mixed economy should be:

- Where market failure occurs, i.e. monopoly, in order to protect the interests of the consumers and prevent the worst excesses of monopoly.
- Where production, if left to the market, would be inefficient due to duplication of plants and capacity, or if produced by a large private monopoly, would lead to excess power over the consumer, i.e. electricity production and supply.
- To maintain services which are important strategically and economically and which may, otherwise, be in danger of collapse.
- To regulate the activities of the private entrepreneur to prevent the worst aspects of private production, i.e. environmental pollution.
- To regulate the economy in order to maintain the level of demand, employment, balance of payments and inflation.

Exercise n.2

THE FREE MARKET ECONOMY and THE PLANNED ECONOMY

As you listen to the presentation, put ticks in the appropriate boxes

	FREE MARKET		PLANNED	
	Strength	Weakness	Strength	Weakness
Resources are allocated in line with the preferences of consumers				
Valuable resources can stand idle				
Production responds to the “price signals”				
Competition forces producers to adopt the least-cost method				
Goods can be distributed according to need rather than income				
Luxury goods can be produced before the basic ones				
“Consumer sovereignty” prevails				
The lack of personal involvement may cause a lack of incentive				
Goods may be produced which consumers do not want				
Necessities will be produced in advance				
Social costs and benefits are allowed for				

Exercise n.3

Open questions

- What are the distinguishing characteristics of a capitalist, free market economy?
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- (a) How does one solve the problem of *what* to produce in a free enterprise, capitalist economy?
(b) in a mixed economy?
(c) in a planned economy?
(a)
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(b)
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(c)
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- How does the price mechanism solve the problem of *how* to produce in a free market economy?

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- How does the price mechanism solve the problem of *for whom* to produce in a capitalist economy?

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