3 Business and economic systems

This chapter covers Unit 1, Module 1, Section 4 of the CAPE syllabus. On completion of this chapter you should be able to:

- explain what is meant by an economic system
- understand the three main decisions that have to be made by every economic system
- evaluate the costs and benefits of a free market economic system
- examine the advantages and disadvantages of other economic systems
- analyse the different methods of measuring business size
- discuss the advantages and disadvantages of small versus large firms

Introduction
There is business activity in some form or other in every country in the world. The nature and level of development of this business activity depends greatly on the type of economic system a country has adopted. There are substantial differences in the economic system employed in some countries. At one extreme are free market economies with very little state intervention. At the other extreme, planned economies allow little private business activity as most resources are controlled by the state. In most countries, the economic system is described as being 'mixed'. The operation of the free market in these countries is balanced by government intervention in many areas and this intervention can have a great impact on business activity and business decisions.

The function of an economy
We have already identified the basic economic problem of scarcity and choice. An economy is a framework or system that attempts to tackle and solve this economic problem. All countries are faced with the issue of scarcity and the need to make choices. They can operate different types of economies in order to approach this problem. These economic systems have to make decisions about three very important issues related to scarcity. These decisions are needed to answer three important questions:

1 What should be produced? – Cars or battle tanks? Hospitals or hotels? Bread or cakes? As resources are scarce – even in the richest countries of the world – it is impossible to make everything that people might want. Choices must be made regarding what is produced. Different economic systems take these decisions in different ways.
2 How should goods be produced? – Using labour or labour-saving machines? Located in towns or in country areas? Using raw materials or recycled products?
3 Who is production produced for? – The few or the many? The unemployed, the sick and the elderly, or just those employed?

Tackling the economic problem – different economic systems
It is usual to classify a country’s economic system into one of four main types.

(a) Traditional or subsistence economies
Traditional economies are based on subsistence living. This means that in these societies nearly all households live and work 'on the land' and try to produce goods to satisfy all of their own needs. Living standards are usually very low as there is very little specialisation or trade. The only exchange that does take place will be in the form of 'barter', where goods of approximately equal value are exchanged between households. Most societies
used to be organised in this way, but there are now very few communities in the world where this traditional system still operates. Greater exposure to more ‘advanced’ economic systems, through travellers and traders, has exposed the failings of the traditional system. Pressure on available land in many countries has meant that those who still attempt to follow the subsistence principle find it very difficult to keep what resources they have. It is likely that these communities that still try to maintain this system will slowly change to an economy based more on specialisation and exchange.

(b) Planned economies

The best examples of countries that adopt ‘central planning’ to allocate resources to production and the completed products to the population are Cuba and North Korea. As planned economies are most closely associated with ‘communist’ political systems, the number of such economies in Eastern Europe was greatly reduced with the ending of communist controls in the early 1990s. The main features of a planned economy are:

- There is state ownership and/or control of most of the economic resources.
- Central state planning decides what should be produced, the production methods to be used and how output should be distributed amongst the population.
- Consumers have little influence over what is produced, and the use of prices to indicate consumer preferences for goods is unimportant.
- There is no competition between producers as all resources are state-owned. There is, therefore, little or no choice for consumers when buying products.

(c) Market economies (or free market economies)

The key features of a market economy are:

- There is private ownership of all economic resources.
- Resources are allocated towards making those products that consumers wish to buy.
- Firms obtain information about the products that consumers most and least want to buy through price levels and price changes. If more consumers want to buy a product then the price on the free market is likely to rise. Firms in the industry will want to produce more because a higher price will allow more profits to be earned.

- Firms operate in order to make profits and will want to increase efficiency to make higher profits.

The role of the government in such countries is very restricted. It is usually limited to providing defence forces and internal police and justice systems, controlling the money supply to prevent serious inflation and, possibly, taking measures to limit extreme monopoly power of unions or businesses.

There are few, if any, examples of pure free market systems in the world today but there are economies that are much closer to this model than others, for example the USA and Taiwan.

(d) Mixed economies

Nearly all economic systems today come into the category of ‘mixed economies’. This means that there is some private business activity – driven by the profit motive – and some state-owned and controlled organisations, often operating for non-profit reasons.

The ‘strength’ of the mixture between private enterprise and state organisations varies considerably. For example, in the UK in 2005 the state controlled around 40% of the total economy by its spending decisions whilst in Sweden it was nearer 65%. The main features of a mixed economy are:

- Many products and services are provided only by private sector businesses not by the state, for example cars, computers and mobile phones.
- Most essential services (often referred to as public goods), such as police, fire service, defence, street lighting, social services and prisons are only provided by the state – yet even this is changing in some countries, with privately owned prisons contracting services to the government.
- Many important goods and services, which can benefit society as well as the consumer (often called merit goods), are provided by both the state and the private sector of
industry, for example schools, health services and broadcasting.

- In order to finance state-operated services, the population pays taxes to the government.
- The government places limits on the nature of business activity by, for example, taking measures to control pollution from factories and by restricting monopoly powers of some firms.

**Evaluation of economic systems**

It is important for students of Business Studies to be aware of these four systems and the different degrees of 'mixture' between private and public sectors that exist in mixed economies. However, mere knowledge of these systems and their differences is rarely going to be examined in detail. Of much more significance for us should be the impact that changes in the 'mixture' or extreme switches from near planned economies to market economies could have on business organisations and the decisions they make. Consider some of these examples:

- How will private sector firms be affected by the large tax increases needed to pay for higher social security payments?
- Will increased controls over location and pollution levels encourage firms to move to other countries?
- If the state decides to sell off some of its own organisations should a business try to take them over?
- Should a multinational invest heavily in a country where the government has just rejected state central planning in favour of a mixed economy?

These and other crucial issues will feature in the remainder of this chapter and in the next two as we consider the nature of business decision making and the impact that state intervention can have on business actions. These are vital areas for any business manager to be aware of. Understanding the advantages and disadvantages of the different economic systems will help provide the foundation for grasping the reasons behind government action and how to respond to it (see Table 3.1).
<table>
<thead>
<tr>
<th>Type of economic system and main features</th>
<th>Possible advantages</th>
<th>Possible disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional or subsistence system:</td>
<td>Sustainable system – there is little negative impact on the environment.</td>
<td>Low living standards.</td>
</tr>
<tr>
<td>† no specialisation,</td>
<td></td>
<td>Poor health and education as there is no government to provide these services.</td>
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<tr>
<td>† little if any trade.</td>
<td></td>
<td>Monopolies might be created as business owners see the gains to be made from reducing competition.</td>
</tr>
<tr>
<td>Free market system:</td>
<td>Profit motive should make firms operate efficiently.</td>
<td>No state support for the elderly, unemployed, etc.</td>
</tr>
<tr>
<td>† private property,</td>
<td>Competition should help to keep prices low and lead to release of new products.</td>
<td>No government control over pollution.</td>
</tr>
<tr>
<td>† profit motive,</td>
<td>Consumers have choices.</td>
<td>Income differences, which are likely to be substantial, not reduced by taxes.</td>
</tr>
<tr>
<td>† price system.</td>
<td>Work is encouraged as taxes are very low, and there will be no state support for non-workers.</td>
<td>No competition to improve product design and keep costs and prices low.</td>
</tr>
<tr>
<td>Planned system:</td>
<td>Central planning prevents duplication and wasteful competition, for example in supply of bus services.</td>
<td>Workers may be poorly motivated – no gains from working harder or showing enterprise to make a business successful.</td>
</tr>
<tr>
<td>† state ownership/control of economic resources,</td>
<td>Production decisions are based on the state's assessment of people's needs – not consumer spending patterns.</td>
<td>Very slow and bureaucratic decision making.</td>
</tr>
<tr>
<td>† very little private sector business activity.</td>
<td>Allows for long-term planning – private firms often interested in short-term profits.</td>
<td></td>
</tr>
<tr>
<td>Mixed economies:</td>
<td>No consumer choice.</td>
<td>Taxes may be heavy to pay for state goods and services – this could reduce incentives to work hard or make profits.</td>
</tr>
<tr>
<td>† private sector business activity encouraged,</td>
<td>State provides essential services for all in society – whether rich or poor.</td>
<td>State organisations can be less efficient than private sector alternatives.</td>
</tr>
<tr>
<td>† state controls resources in supply of certain goods and services,</td>
<td>Private sector still encouraged to be successful and allowed to earn profits from enterprise.</td>
<td>Excessive controls over business activity can add to costs and discourage enterprise.</td>
</tr>
<tr>
<td>† taxes used to collect revenue to pay for state goods and services.</td>
<td>Competition allows the advantages seen in a free market economy.</td>
<td></td>
</tr>
</tbody>
</table>

Table 3.1 Different economic systems – advantages and disadvantages check list.
Impact of economic systems on business organisations’ size and growth

In **traditional economies** each family household tries to meet its own needs so there are no true business enterprises. If some trade is conducted, for example in craft goods or surplus food, this will be on a very small scale, possibly with business enterprises from ‘outside’ of the traditionally organised community.

**Planned economies** tend to have very large state-owned business organisations. So, for example, all of the electricity generated in the country will be provided by the state-owned power corporation. Farming will be controlled by huge state-owned and managed cooperatives. There will be just one state-run airline, and so on.

**Free market economies** may have both many small businesses as well as large privately owned monopolies. This will depend on the level of competition in the market. Many small competing businesses are likely in hairdressing and retailing, for example. In industries where there are substantial scale economies there may be just one large monopoly producer with no close substitutes. This might be the case in computer manufacturing or sugar refining.

In **mixed economies** there will be a combination of both large state-owned public corporations – in the power industry or the railways, for example – and privately owned businesses of different sizes.

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**Activity**

**Problem of defining size**

<table>
<thead>
<tr>
<th>Supermarket</th>
<th>Employees</th>
<th>Capital employed ($m)</th>
<th>Sales turnover ($m)</th>
<th>Selling space (Sq. metres)</th>
<th>No. of outlets</th>
</tr>
</thead>
<tbody>
<tr>
<td>W</td>
<td>300</td>
<td>150</td>
<td>250</td>
<td>55,000</td>
<td>15</td>
</tr>
<tr>
<td>X</td>
<td>800</td>
<td>500</td>
<td>1,200</td>
<td>300,000</td>
<td>20</td>
</tr>
<tr>
<td>Y</td>
<td>1,200</td>
<td>700</td>
<td>1,000</td>
<td>400,000</td>
<td>35</td>
</tr>
<tr>
<td>Z</td>
<td>1,500</td>
<td>400</td>
<td>400</td>
<td>150,000</td>
<td>40</td>
</tr>
</tbody>
</table>

(26 marks, 30 minutes)

1 Which business is largest using the following measures of size:
   - employees,
   - capital employed,
   - sales turnover,
   - selling space,
   - market share if total market size = $4,000m,
   - number of outlets? (6)

2 What do your results tell you about your attempt to measure business size? (5)

3 Explain which would be the preferred measure of size in the following circumstances:
   - the government wishes to identify the supermarket with the greatest degree of monopoly power; – **market share**
   - a bank wishes to lend money to the business with the largest capital structure; – **capital employed**
   - a shareholder wishes to invest in the business with the greatest sales potential. (9)

4 What can you conclude about the levels of efficiency of these four businesses? (6)