



Economic System: is the process through which resources are **allocated (divide)** between production of different goods.

The system that is used to decide **what goods and services should be produced** in an economy / country is known as the Economic System.

There are 3 fundamental questions that every economic system needs to answer:

1. **What to Produce?** (what goods or services should a country produce)
2. **How to produce?** (what resources should be used to produce those products)
3. **For whom to produce?** (how will the produced goods / services be distributed amongst the citizens)

Types of Economic Systems:

- a) Free Market / Market Economy
- b) Mixed Economy
- c) Command Economy / Planned Economy

Mixed Economy: presence of both public and private sectors. The public sector produces public goods and the private sector produces private goods.

Public Sector: an organization / business activity that is owned and managed by the government. These businesses are focused on social welfare and they are not profit-maximizing entities.

Private Sector: an organization / business that is owned by people / private individuals. These businesses are profit maximizing entities.

Public Good: is a product (good / service) that is non-excludable and non-rivalry.

Private Good: is a product that is excludable and rivalry.

Excludable: is any product that has clearly defined property rights and someone owns that product like a car, a house, a phone.

Non-Excludable: either the property rights are not clearly defined or it is jointly owned by the people in a country. Example Road, defense, street lights, parks (public space)

Rivalry: when the benefit of a product diminishes as more people use the good. Example a car, a house, a laptop.

Non-Rivalry: is when the product's benefit does not diminish as more people use the good. Example a road, highway,

Education - Quasi - Public Good

Health Care - Quasi - Public Good

Clothes -

Drinking Water -

Food -

Electricity -

Cell phone

Car

Laptop

Pure Public Goods

Parks

Street Lights

Defence

Roads

Education: can be excludable because if someone is not paying for it then you can remove the person from receiving the benefit.

- If a classroom is very crowded the teacher's attention will be diluted and therefore students will not get as much attention as much they could have in less crowded classrooms. And therefore in a way addition of more students to classroom diminished the existing students' benefit. This is what makes education rivalry.

Classification of Goods

Public versus Private Goods

Merit versus Demerit

Demerit Goods: any product that is harmful for the consumer but they do not fully realize the harmful effect and therefore they overconsume it. Example cigarettes, junk food, alcohol

Merit Goods: products that are beneficial for consumers but they under consume it because they do not fully realize the benefits. Example education, health care, healthy food, exercise.

How Mixed Economy Operate?

Resources are almost equally split between public and private therefore we can say that both sectors are equally important in terms of contributing to the country's output.

Role of Private Sector:

- ***What to the Produce? Anything that is profitable*** even demerit goods
- ***How to Produce?*** Will employ resources that are ***cheapest*** assuming that the quality of output is constant.
- ***For whom to produce?*** The people with ***affordability*** will be able to buy the good only.

Profit = Revenue - Cost

Revenue: is the total receipt for a business from the sale of its products

Cost: the total expense incurred in producing the products

Role of Government in the Mixed Economy:

1. ***What to Produce?*** Public goods like defence, street lights, roads, parks and also merit goods like education and health care
2. ***How to Produce?*** Government will try creating more jobs and in the process they are more likely to be labor intensive (employ as many people as much they can)
3. ***For whom to produce?*** So the distribution of public and merit goods produced by the govt is ***not on the basis of affordability but instead on the basis of need.***

Even though public education and public health care is available to all citizens of the country but the rich individuals opt out for it since they can afford better quality services through private sector and therefore it puts less pressure on government resources.

Apart from producing public and merit goods in a mixed economy the government also has the role of making regulations. Regulations are policies, rules to control certain socially harmful behavior of individuals / companies etc. For instance if the government observes that some

company is exploiting its employees then the government will make rules and policies around that.

Market Economy / Free Market Capitalism

Capitalism believes in market forces. If a consumer needs / wants something then it should be provided.

Most resources are privately owned and it is the private sector that is producing **most** products in the country and the **role of government is only limited to provision of public goods. Hence government intervention is minimal.**

Point to Remember: private sector never produces public goods. Why?

It is not possible for a private company to charge for public goods which are non-excludable in nature and therefore it is not profitable for private businesses to produce public goods.

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Command Economy / Planned Economy

Communism

It is complete opposite of free market which means most resources in the country will be government owned and therefore the government decides what to produce, how to produce and for whom to produce.

There is no private ownership of resources in the command economy.

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Pros and Cons of Different Economic Systems

Free Market

Pros	Cons
There are multiple firms producing same products which provides variety of goods for customers	Private business will produce any product that is profitable even if it is a demerit good
Since there are multiple firms producing a product like restaurants then consumers will choose brands that are relatively better quality and more affordability.	Then there is no government intervention that regulates the behaviour of private sector like monopolies or pollution or other socially harmful activities Which can lead to consumers' and workers' exploitation
Private sector businesses are more responsive to changes in customers' demand. And if there is demand for a product the sooner or later the private sector will produce that.	The private sector will not provide education and health care only to those who cannot pay for it.
Since there is competition among firms therefore each firm will try to keep prices low and in the process they aim for efficiency.	There is more income and wealth inequality in Free Market since privileged people have access to better education, health care and finance and therefore they are more likely to create more income and wealth for themselves in the future.

Command Economy

PROS	CONS
<p>There is relatively more equality between the citizens' living standards because the government is providing standardized products to everyone including education, health care, housing, consumer products etc.</p>	<p>There is limited competition and therefore consumers do not have much choice of goods / services to choose between.</p> <p>One government firm produces a certain product which significantly reduces consumers' choice. And these firms make standardized products which do not account for different needs of the customers.</p>
<p>There is more provision of public and merit goods.</p> <p>And restrictions or complete prohibition on production of demerit goods.</p>	<p>Since the government is not a profit making entity, it will not be much concerned about minimizing costs and making best possible use of resources.</p> <p>PIA is overstaffed, which is one major reason for its huge amounts of losses which are eventually financed through government budget from the taxpayers money.</p>
<p>Local firms are protected from foreign competition which results in higher local employment</p>	<p>There is limited or no innovation because there are profit incentives.</p>

Mixed Economy

<i>Pros</i>	<i>Cons</i>
More choice compared to command economy	Excessive regulation will create disincentives for business and individuals and therefore there can be outwards flow of investment which will make the country lose potential jobs, potential output and development.
Private sector will be focuses on producing better quality and more affordable products	There can be duplication of resources which is inefficient.
Subsidies are provided to the private sector to reduce prices of important products like food, education, health care.	Government organizations sometime might be restricting the growth of the private sector.
There is greater balance of public and private goods as the private sector produces private goods and the public sector produces public goods.	
More regulation to ensure that individuals' rights are not infringed by other individuals or businesses etc.	

Important Terms

Division of Labor: is when a big project is divided into smaller parts / activities and then every person is made to specialize in one particular activity.

Average Cost of Production: the cost of producing a typical unit of a good. Average cost of production always decreases when there is division of labor.

Total Cost = \$250 Total Quantity = 5

Productivity: it means efficiency which is basically the output produced with a certain amount of input.

When there is division of labor there is higher productivity.

Normative Statement: is an opinion which is subjective and therefore cannot be verified. Words like should, indicate that it is an opinion.

Positive Statement: any statement that is a fact or something that can be verified with globally accepted standards is a positive statement.

Economics: is the study of resources and how resources can be used to produce goods and services.

Basic Economic Problem: all countries and individuals in the world have limited resources and unlimited wants. It is also known as Scarcity.

Types of Taxes:

**Progressive -
Proportional**

Regressive - poor people pay a bigger proportion of their income in taxes compared to the rich people.