

FUNCTION OF AN ECONOMIC SYSTEM

1. Define an economic system.

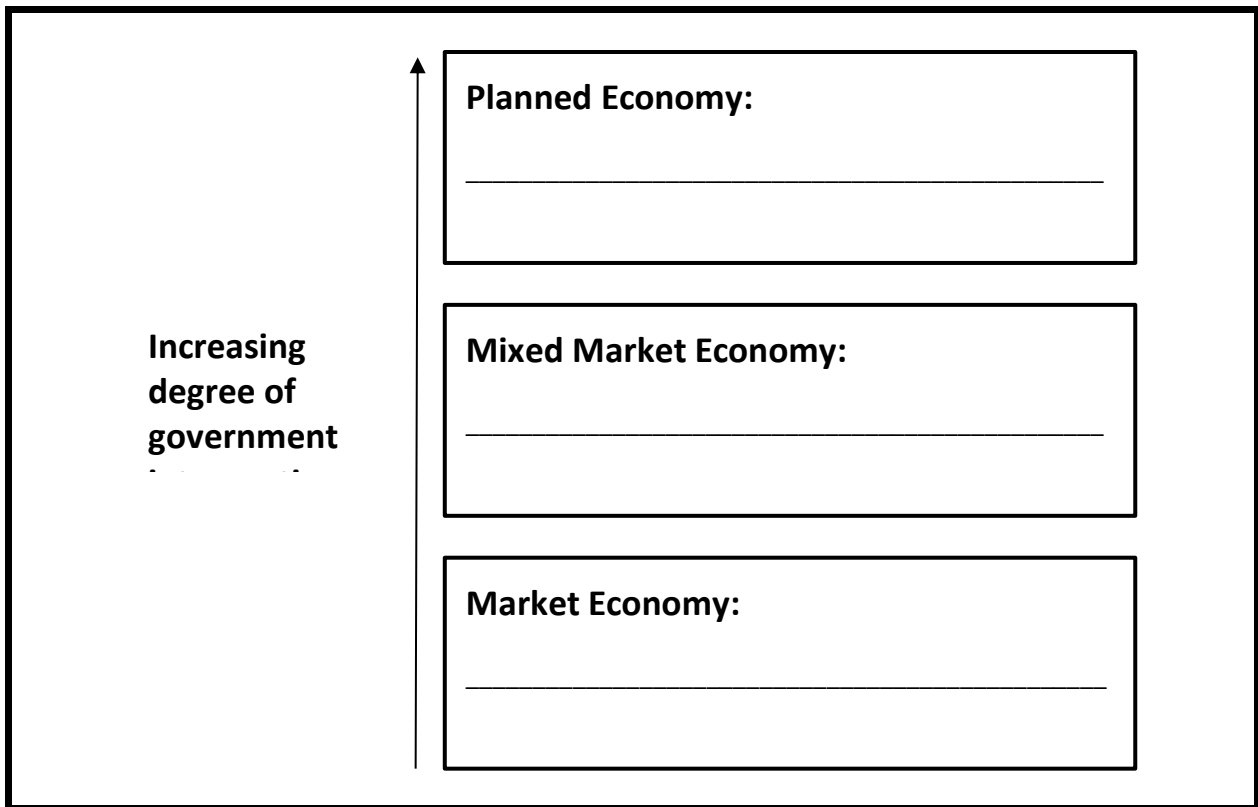
- An **economic system** refers to how a particular societal group organises its patterns of production, resource allocation, and distribution of goods and services.
- Although different economic systems exist, they all seek to organise themselves in a way which addresses the **economic problem**

Question 1: Identify the three main types of economic systems. (1 mark)

Question 2: Outline what the economic problem/the issue of scarcity is. (2 marks)

2. Draw and label a straight-line diagram to represent a classification of economic systems according to government involvement. Name a country, which is characterised by each type of economic system you identify.

- Essentially, we can classify the three types of economies based on the **degree of government intervention** involved, and consider examples of each
 - I.e. a low vs high degree of government intervention in one country vs another



3. No two economies are exactly the same but all economies perform certain fundamental functions. Explain.

- Although different economic systems do indeed exist, they share several key similarities
- All types of economies seek to organise themselves in a way which addresses the economic problem
- In order to do so, they each attempt to ask and subsequently **address four fundamental questions** concerning the production and distribution of goods and services

Question 3: Identify the four fundamental questions concerning the production and distribution of goods and services which economies attempt to address when solving the economic problem?. (4 marks)

4. What are the features of a planned economy?

- A **planned economy** is one in which the government determines outcomes in regards to the production and distribution of goods and services, with little room for the action of market forces of supply and demand
- **Key features** of a planned economy include:
 - Public ownership of property and resources
 - The absence of freely operating product and factor markets
 - That is, prices are not determined by the interaction of supply and demand, but rather the government
 - Accordingly, production is dominantly carried out by state-owned and operated enterprises in alignment with national interests rather than individual firms
 - A dominant role is played by the government in economic, political, military and cultural life; little room for self-guided motivation

5. How does a planned economy attempt to solve its basic economic problem?

- **Recap:** all economies attempt to solve the economic problem by addressing **four fundamental questions** concerning the production and distribution of goods and services.
- A planned economy attempts to address these questions in a unique manner, as follows.
- **What and how much to produce:**
 - Decided by the government's delegated central planning agency, which establishes short, medium and long term plans
 - These plans set out production priorities that reflect national interests (e.g. the production of goods for national defence)
 - Allocation of resources is also done by the government, with producers such as farms and factories being given production targets or quantities to meet based on the level of resources given
- **How to produce:**
 - Production methods in planned economies are determined by the government based on the quantity/quality of available resources
 - Planned economies may engage in less trade if government interests are in favour of being closed off, resulting in a more limited supply of productive resources
 - In terms of labour resource allocation, state planners implement differential wage structures to encourage an adequate supply of workers into priority areas established by the government
 - If there is an inadequate supply, coercion or forced labour may be relied upon to meet production targets
- **To whom to distribute:**
 - The government decides how to ration or share out production on the basis of need and areas of state priority
 - Workers in priority areas receive higher wages and salaries as they are more integral to the overall performance of the economy
 - Basic necessities such as food, water and housing are often subsidised or provided for free, allowing for basic sufficiency in regards to living standards for majority of the population

6. Outline the advantages and disadvantages of a planned economy.

Advantages	Disadvantages
<ul style="list-style-type: none"> ● Low levels of inequality ● Low unemployment 	<ul style="list-style-type: none"> ● Lack of efficiency and competition ● Potential wastage of resources

Question 4: Explain one advantage or one disadvantage of a planned economic system (2 marks).

7. What features distinguish a market economy from a planned economy?

- The key differentiating characteristic between a market economy and a planned economy is the **degree of government intervention** in the economy
- In a market economy, the role of the government is extremely limited
- Conversely, as we previously mentioned, the government has an integral role in guiding the general operations of a planned economy

8. How does the market economy answer the fundamental questions concerning the production and distribution of goods and services?

- **What to produce and how much to produce:**
 - Determined by the price mechanism and the nature of consumer preferences at the time
 - E.g. producers want to maximise profits by only producing a large quantity of goods that are in high demand, rather than producing a large quantity of goods in low demand which would result in a substantial wastage of resources and loss of potential profits
- **How to produce:**
 - Decisions in regards to the methods of production are made in line with the **profit motive**

- Producers wish to use production methods that yield the lowest net cost to the firm, which in turn allows for profits to be maximised
- Production methods will also rely on the level/quality of resources and technology at the time
 - Market economies are more open to trade, so high quality raw materials and technology can be readily imported
- **To whom to distribute:**
 - Determined by the distribution of factor incomes, although this system results in a greater degree of overall inequality within the economy
 - Higher incomes enable people to purchase more goods and services

9. Discuss the role played by the price mechanism in a market economy.

- The **Price mechanism** refers to the system whereby the market forces of supply and demand are relied on to determine the prices of goods and services and the changes therein
- It is the main device for resource allocation in product and factor markets
 - E.g. if the price mechanism allocates a low price towards a certain good or service which is a suitable substitute for a more expensive item, we may become tempted to purchase it instead
 - Resultantly, higher demand for that good/service may then encourage firms to produce more of it, which will result in a price increase and potentially a fall in demand in the long-run as demand becomes more elastic

10. Briefly examine the main problems with leaving a market economy to function by itself without any government intervention.

- The government may be seen as crucial to the optimal operation of the economy due to its potential to perform the following roles:
 - Regulator and enforcer of laws which could protect consumers from exploitation and unethical practices by firms
 - Provider of public goods and services such as defence, health and education that generally benefit society as a whole
 - The private sector is reluctant to provide these due to the lack of profit involved
 - Promoter of a more equitable distribution of income (and subsequently wealth) through means such as the progressive taxation system or the conduct of transfer payments

- Stabiliser of economic activity through the conduct of counter cyclical policies (such as monetary and fiscal policies)

11. Define the term mixed economy.

- Market economy, but characterised by some degree of government intervention.
- The private sector makes majority of economic decisions, but the government plays an important role in the economy

12. Discuss the characteristics that make Australia a mixed economy.

- Australia is considered a mixed economy
- Aside from solely relying on market forces of supply and demand to determine outcomes, the government possesses some key roles in the economy, as mentioned above (refer to question 10)

Question 5: Describe two roles possessed by the Australian government in the economy (4 marks).
