Planned vs Market Economy

While there are many different variations of national economies, the two dominant economic coordination mechanisms are centrally planned and market based. Before you can analyze any national economy, you need to understand these two opposing viewpoints on how to run an economy. The key difference between the two is the amount of individual autonomy within the two systems.

Centrally Planned Economy

A pure planned economy has one person or group who controls what is produced; all businesses work together to produce goods and services that are planned and distributed by the government. These economies are also called command economies because everyone must follow specific guidelines set up by the controlling authority. The reason behind this type of planning is to make sure that everything needed is produced and that everyone's needs are fulfilled. Since most peoples' needs are provided for in a centrally planned economy, compensation is primarily morally based. Most assets are owned by the state.

Planned economies have several advantages. Ideally, there is no unemployment and needs never go unfulfilled. Because the government knows how much food, medicine, and other goods is needed, it can produce enough for all. But achieving these outcomes depends on the group that organizes production and distribution to accurately identify what the consumers will need, determine what it would take to meet those goals, and anticipate all possible situations. This means there are a lot of opportunities to make a mistake. Realistically, these systems tend to suffer from large inefficiencies and are overall not as successful as other types of economic systems.

Market Based Economy

A pure market economy, or capitalist system, is perfectly free from external control. Individuals may decide what to produce, who to work for, and how to get the things they need. They are compensated with material goods for their work, and most assets are privately owned. This type of economy, though it may be chaotic at times, allows people to change along with the shifting market conditions to maximize their profits. Although they avoid many of the
inadequacies of planned economies, market economies are not free of their own problems and downfalls. Perhaps the greatest problem is that business firms may refuse to produce goods that unprofitable for them. For instance, in 2000 there was a shortage of tetanus vaccine in the United States. Because it was expensive to make, most companies were unwilling to start production themselves, leaving only one firm struggling to keep up with demand. In a planned economy, this shortage would not happen because the government would boost production of the vaccine if it were needed.

Because there is no regulation to ensure equality and fairness, market economies may be burdened with unemployment and even those with jobs can never be certain that they will make enough to provide for all of their needs. Despite these and other problems, market economies come with many advantages, chief among which is speed. Because they do not need to wait for word from the government before changing their output, companies under market economies can quickly keep up with fluctuations in the economy, tending to be more efficient than regulated markets. Also, individuals have more freedom and opportunities to do the jobs they want and to profit by them.

Market Economy

A market economy is where economic decisions are made by the free market. That means production of goods and services are regulated by the laws of supply and demand. Producers sell their goods and services at the highest possible price that consumers are willing and able to pay. Workers also bid their services at the highest possible wages that their skills allow.

It is generally thought that any market economy got its start as a traditional or command economy. However, most societies in the modern world have elements of all three, and are therefore mixed economies.

Characteristics of a Market Economy

A market economy is defined by six characteristics:

1. Private Property -- Most goods and services are privately-owned. This allows the owners to make legally binding contracts to buy, sell, lease or rent their property. In other words, their property gives them the right to profit from ownership. However, there are exclusions to what is considered private property. For example, since 1865 the U.S. does not allow you to buy and sell other people, or even yourself. This includes your own body or body parts.

2. Freedom of Choice -- Owners, businesses, consumers and workers are free to produce, sell and purchase goods and services in a free market. Their only constraint is the price they are willing to buy or sell for, and the amount of capital they have.

3. Motive of Self-interest -- The market is driven by everyone trying to sell their goods or services to the highest bidder, while at the same time paying the least for the goods and services they need. Although the motive is selfish, it works to the benefit of the economy over the long run. That's because this auction system fairly prices all goods and services, accurately depicting true supply and demand at any given point in time.

4. Competition -- The forces of competitive pressure keeps prices moderate, and ensure that goods and services are provided most efficiently. That's because, as soon as demand increases for a particular item, prices rise thanks to the law of demand. As competitors see there is additional profit to be made, they start production, adding to supply. This lowers prices to a level where only the best competitors remain. This force of competitive pressure also applies to workers, who are competing with each other for the highest-paying jobs, and consumers, who are competing for the best product at the lowest price.

5. System of Markets and Prices -- A market economy is completely dependent on an efficient market in which to sell goods and services. In an efficient market, all buyers and sellers have equal access, and the same information upon which to base their decisions. Prices rise and fall freely depending purely on the laws of supply and demand.

6. Limited Government -- The role of government is simply to ensure that the markets are open and working. For example, it is in charge of national defense so no other country can destroy the markets. It also makes sure that everyone does have equal access to the markets. For example,
government exerts penalties on monopolies, which unfairly restrict competition. The government watches to make sure no one is unfairly manipulating those markets, and that all information is distributed equally.

**Market Economy Advantages**

Since a market economy allows the free interplay of supply and demand, it also ensures the most desired goods and services are produced. That's because consumers are willing to pay the highest price for the things they want the most. Businesses will only produce those things that return a profit.

Good and services are produced in the most efficient way possible. The most efficient producers will receive more profit than less efficient ones.

Innovation is rewarded. Producers who are innovative will come up with more efficient methods of production. Innovation of new products will meet the needs of consumers in better ways that existing goods and services. This innovation will spread to other competitors so they, too, can be more profitable.

The businesses and individuals who are most efficient and innovative will accumulate more capital. They can invest this in other efficient and innovative companies, giving them a leg up and leading to an overall higher quality of production.

**Market Economy Disadvantages**

A market economy functions through competition. However, there are many people in a society who are at a natural competitive disadvantage, such as the elderly, children, and mentally or physically challenged people. In addition, the caretakers of those people are also at a disadvantage, because their energies and skills are taken up with caretaking, not competing. Thus, a society based on a pure market economy must decide whether it's in its larger self-interest to set aside resources to make sure they get their needs met, or whether to let them just fall by the wayside.

A market economy rewards those who are good at being competitive. Therefore, the society reflects the values of those people and organizations. This explains why a market economy may produce private jets for some while others starve and are homeless.
Planned/Command Economy

A command economy is where economic decisions are planned out in detail by a central government authority. The plan is implemented through laws, regulations and directives. Businesses follow production and hiring targets instead of individually and freely responding to the laws of supply and demand. Central planners seek to replace the forces that operate in a market economy, and the customs that guide a traditional economy, to attain specific societal goals. They may also use aspects of a command and market economy as part of a mixed economy.

The concept of a command economy was developed by Viennese economist Otto Neurath as a method to control the hyperinflation after World War I. The phrase comes from the German "Befehlswirtschaft" and was initially used to describe the Nazi economy. However, centrally planned economies were in existence before then, including the Incan empire in 16th century Peru, the Mormons in 19th century Utah, and even the U.S. during World War II mobilization.

Characteristics of a Command Economy

A modern centrally planned economy can be identified by the following five characteristics:

1. The government creates a central economic plan for all sectors and regions of the country. It typically starts with a five-year plan to set the overriding economic goals. This is broken down into shorter-term plans to convert the goals into actionable objectives. The goal of the five-year plan is to generate robust economic growth, increase production efficiency and best utilize scarce resources. For the most part, a command economy needs a political system that is also centrally planned.

2. The government allocates all resources according to the central plan. The goal is to use the nation's capital, labor and natural resources in the most effective way possible. This pretty much eliminates unemployment by promising to use each person's skills and abilities to their highest capacity.

3. The central plan sets the priorities for production of all goods and services. The goal is to supply enough food, housing and other basics to meet the needs of everyone in the country. In addition, it may have other priorities, such as mobilizing for war or increasing the nation's economic growth.

4. The government owns a monopoly business in industries deemed important to the goals of the economy. This usually includes finance, utilities, and automotive. There is no domestic competition in these industries.

5. The government creates the laws that regulate economic activity. These include regulations, directives and wage/price controls to implement the central plan.
Command Economy Advantages

Centrally planned economies are great at mobilizing economic resources quickly, effectively and on a large scale. They can execute massive projects, create industrial power and attain imperative social goals. They are able to override individual self-interest, and subjugate the welfare of the general population, to achieve a greater agreed-upon goal for the society at large.

Command economies are also good at wholly transforming societies to conform to the planner's vision, as in Stalinist Russia, Maoist China and Castro's Cuba. For example, the command economy in Russia built up an effective military might and quickly rebuilt the economy after World War II.

Command Economy Disadvantages

This rapid mobilization often means command economies mow down other societal needs. For example, workers are often told what jobs they must fulfill and are even discouraged from moving. However, people won't ignore their own needs for long. They often develop a shadow economy, or black market, to buy and sell the things the command economy isn't producing. The efforts of leaders to control this market can ultimately weaken support for the central planning authority.

Instead of leading to efficiency, command economies often produce too much of one thing and not enough of another. That's because it's difficult for the central planners to get up-to-date information about consumers' needs. In addition, prices are set by the central plan, and so can't be used to measure or control demand. Instead, rationing often becomes necessary.

Command economies are not good at stimulating innovation. Businesses are focused on following directives, and are discouraged from making any autonomous decisions.

Centrally planned economies also have trouble producing the right exports at global market prices. It's difficult for the various planning sectors to coordinate with each other, not to mention foreign countries' needs.

Command Economy Examples

Cuba, North Korea, China, Russia and Iran are the most commonly referenced examples of command economies. Russia's Gosplan has been the most studied. It was also the longest running, lasting from the 1930s until the late 1980s.