**Capitalist Economy**

Capitalism is the most prominent in our current global economic system. Its main characteristic is that it most means of [production](https://www.toppr.com/guides/business-economics/theory-of-production-and-cost/meaning-of-production/) and property are privately owned by individuals and [companies](https://www.toppr.com/guides/business-studies/forms-of-business-organisations/types-of-companies/). The government has a limited role in such an economy limited to [management](https://www.toppr.com/guides/business-studies/nature-and-significance-of-management/levels-and-functions-of-management/) and control measures.

So a capitalist economy is a liberal economy. This means only the free market will determine the [supply](https://www.toppr.com/guides/business-economics/theory-of-supply/law-of-supply/), [demand](https://www.toppr.com/guides/economics/theory-of-consumer-behaviour/demand-curve-and-the-law-of-demand/), and [prices of the products](https://www.toppr.com/guides/business-studies/marketing/pricing/). There is no direct government intervention other than to control [monopolistic](https://www.toppr.com/guides/business-economics-cs/analysis-of-market/monopolistic-competition/) practices in the economy.

As we said earlier a [capitalist economy](https://www.toppr.com/guides/business-economics/introduction-to-business-economics/capitalist-economy/) is the most predominant in the current global economy. USA, UK, Germany, Japan, Singapore all are classic examples of capitalist economies.

**Features of a Capitalist Economy**

* **Right to Private Property:** This is the essence of capitalism. This right means that private property such as property, factories, machines, [plants](https://www.toppr.com/guides/biology/life-processes/nutrition-in-plants/) etc. can be owned under private individuals and companies. The three things covered under this right are:  
  Every individual can acquire any amount of property, He can use these properties as he wishes, He also has the right of [inheritance](https://www.toppr.com/guides/evs/like-father-like-daughter/inheritance/). So he can inherit the property from his forefathers. And he can also pass it on to his successors on his death.
* **Price Mechanism**: Price mechanism is like an invisible hand that controls the workings of a capitalist economy. The forces of supply and demand will determine the prices and the level of productions in the economy. The government will not have any interference in this matter.
* **Profit Motive**: The driving force behind any capitalist economy is the profit motive. All companies wish to produce and sell their products to maximize their profits. This also induces healthy competition in the economy.
* **Freedom of Enterprise**: In capitalism, every individual is free to make his own economic choices without any intervention. This includes both the [consumer](https://www.toppr.com/guides/economics/consumer-rights/rights-of-consumers/) and the producers.  
  So a producer is free to produce any goods or services. And the consumer is free to buy whatever he desires and from whomever, he wants without restrictions.

#### Pillars of capitalism

Capitalism is founded on the following pillars:

* *private property*, which allows people to own tangible assets such as land and houses and intangible assets such as stocks and bonds;
* *self-interest*, through which people act in pursuit of their own good, without regard for sociopolitical pressure. Nonetheless, these uncoordinated individuals end up benefiting society as if, in the words of Smith’s 1776 Wealth of Nations, they were guided by an invisible hand;
* *competition*, through firms’ freedom to enter and exit markets, maximizes social welfare, that is, the joint welfare of both producers and consumers;
* *a market mechanism* that determines prices in a decentralized manner through interactions between buyers and sellers—prices, in return, allocate resources, which naturally seek the highest reward, not only for goods and services but for wages as well;
* *freedom to choose* with respect to consumption, production, and investment—dissatisfied customers can buy different products, investors can pursue more lucrative ventures, workers can leave their jobs for better pay; and
* *limited role of government*, to protect the rights of private citizens and maintain an orderly environment that facilitates proper functioning of markets.

### Feudalism the Root of Capitalism

Capitalism grew out of European feudalism. Up until the 12th century, less than 5% of the population of Europe lived in towns. Skilled workers lived in the city but received their keep from feudal lords rather than a real wage, and most workers were serfs for landed nobles. However, by the late Middle Ages rising urbanism, with cities as centers of industry and trade, become more and more economically important.

The advent of true wages offered by the trades encouraged more people to move into towns where they could get money rather than subsistence in exchange for labor. Families’ extra sons and daughters who needed to be put to work, could find new sources of income in the trade towns. Child labor was as much a part of the town's economic development as serfdom was part of the rural life.

### Mercantilism Replaces Feudalism

[Mercantilism](https://www.investopedia.com/terms/m/mercantilism.asp) gradually replaced the feudal economic system in Western Europe and became the primary economic system of commerce during the 16th to 18th centuries. Mercantilism started as trade between towns, but it was not necessarily competitive trade. Initially, each town had vastly different products and services that were slowly homogenized by demand over time.

After the homogenization of goods, trade was carried out in broader and broader circles: town to town, county to county, province to province, and, finally, nation to nation. When too many nations were offering similar goods for trade, the trade took on a competitive edge that was sharpened by strong feelings of nationalism in a continent that was constantly embroiled in wars.

Colonialism flourished alongside mercantilism, but the nations seeding the world with settlements were not trying to increase trade. Most colonies were set up with an economic system that smacked of feudalism, with their raw goods going back to the motherland and, in the case of the British colonies in North America, being forced to repurchase the finished product with a pseudo-[currency](https://www.investopedia.com/terms/c/currency.asp) that prevented them from trading with other nations.

It was Adam Smith who noticed that mercantilism was not a force of development and change, but a regressive system that was creating trade imbalances between nations and keeping them from advancing. [His ideas for a free market](https://www.investopedia.com/updates/adam-smith-economics/) opened the world to capitalism.

### Growth of Industrial Capitalism

Smith's ideas were well-timed, as the [Industrial Revolution](https://www.investopedia.com/terms/i/industrial-revolution.asp) was starting to cause tremors that would soon shake the Western world. The (often literal) gold mine of colonialism had brought new wealth and new demand for the products of domestic industries, which drove the expansion and mechanization of production. As technology leaped ahead and factories no longer had to be built near waterways or windmills to function, industrialists began building in the cities where there were now thousands of people to supply ready labor.

Industrial [tycoons](https://www.investopedia.com/terms/t/tycoon.asp) were the first people to amass their wealth in their lifetimes, often outstripping both the landed nobles and many of the money lending/banking families. For the first time in history, common people could have hopes of becoming wealthy. The new money crowd built more factories that required more labor, while also producing more goods for people to purchase.

During this period, the term "capitalism"—originating from the Latin word "capitalis," which means "head of cattle"—was first used by French socialist Louis Blanc in 1850, to signify a system of exclusive ownership of industrial means of production by private individuals rather than shared ownership.

Contrary to popular belief, Karl Marx did not coin the word "capitalism," although he certainly contributed to the rise of its use.

### Industrial Capitalism's Effects

Industrial capitalism tended to benefit more levels of society rather than just the aristocratic class. Wages increased, helped greatly by the formation of unions. The [standard of living](https://www.investopedia.com/terms/s/standard-of-living.asp) also increased with the glut of affordable products being mass-produced. This growth led to the formation of a [middle class](https://www.investopedia.com/terms/m/middle-class.asp) and began to lift more and more people from the lower classes to swell its ranks.

The economic freedoms of capitalism matured alongside democratic political freedoms, liberal individualism, and the theory of natural rights. This unified maturity is not to say, however, that all capitalist systems are politically free or encourage individual liberty. Economist [Milton Friedman](https://www.investopedia.com/terms/m/milton-friedman.asp), an advocate of capitalism and individual liberty, wrote in Capitalism and Freedom (1962) that "capitalism is a necessary condition for political freedom. It is not a sufficient condition."

A dramatic expansion of the financial sector accompanied the rise of industrial capitalism. Banks had previously served as warehouses for valuables, clearinghouses for long-distance trade, or lenders to nobles and governments. Now they came to serve the needs of everyday commerce and the intermediation of credit for large, long-term investment projects. By the 20th century, as [stock exchanges](https://www.investopedia.com/terms/e/exchange.asp) became increasingly public and investment vehicles opened up to more individuals, some economists identified a variation on the system: [financial capitalism](https://www.investopedia.com/articles/07/financial-capitalism.asp).

### **The main merits of this system are:**

#### (i) Economic Freedom:

The foremost advantage of this system is that everybody enjoys’ economic freedom as one can spend one’s income according to one’s wishes. Producers have complete freedom to invest in any business or trade.

#### (ii) Automatic Working:

Another advantage according to classical economists is an automatic system. Equilibrium point is automatically come with the forces of demand and supply.

#### (iii) Variety of Goods and Services:

All the basic decisions of what to produce, how to produce and for whom to produce are taken by producers. Every producer gives attention to consumers’ taste and preferences. Hence, there are large variety of goods and services; produced in the economy.

#### (iv) Optimum Use of Resources:

All natural resources are used to their optimum level as production is undertaken with a sole purpose: of earning profit and no scope for wastages at all.

#### (v) Efficient Producer:

There is very tough I competition among entrepreneurs. They always encouraged to produce best quality of products. Thus, technical development will lead to increase in higher productivity as well as efficiency.

#### (vi) Higher Standard of Living:

Varieties of goods at cheap rates make it easy to be within the; reach of poor and weaker sections of society. This results in rise in their standard of living.

#### (vii) Incentive to efficient:

In this system, incentives are given to the efficient workers in cash or kind. This means every worker should get reward according to his ability. Hence, workers will try to work more and more, therefore, total output will also increase.

#### (viii) New Inventions:

In this type of economy, there is ample scope of new invention. To get more profit every producer takes initiative to develop new techniques in production.

### Demerits of Capitalistic System:

According to Karl Marx, “Capitalism contains the seeds of its own destruction.”

**The main demerits of this system are given below:**

#### (i) Labour Exploitation:

The main defect of capitalism is the exploitation of labour. Labourers get less wages in comparison to their working hours. The wages less than their marginal productivity are not sufficient for their livelihood.

#### (ii) Class Struggle:

A lion’s share of income and resources is controlled by the upper sections of the society, while others remain deprived of the basic amenities of life. Thus, the entire society is divided between ‘haves and ‘have not’s. Hence, the continuous class struggle spoils the health environment of the economy.

#### (iii) Wasteful Competition:

Capitalism is a wasteful competition. A lot of money is spent on advertisement and publicity for pushing the sale of the commodity. Its burden ultimately is borne by the poor consumers in the form of increased price.

#### (iv) Threat of Over-Production:

The production is made on a large scale which cannot be changed in a short period. Therefore, under capitalism, fear of over-production always exists. The Great Depression of 1930s in USA is an example of it.

#### (v) Economic Fluctuations:

Being automatic in nature, capitalist economy always faces the problem of economic fluctuations and unemployment. This means the state of instability and uncertainty,

#### (vi) Unbalanced Growth:

All the resources are put only to those channels where there is maximum profit. Other sectors of the economy are neglected. As there is no check on the economic system, the growth is unbalanced in nature.

#### (vii) No Welfare Activities:

In capitalism, the sole motive is maximum profit, but not the public welfare. Variety of goods are produced according to market demand, not for any welfare activity.

#### (viii) Monopoly Practices:

This economic system has been criticised on the fact that it develops monopoly activities within the country.

**Socialism**

Socialism refers to the government ownership of the means of production, planning by the government and income distribution”-Samuelson.

**Meaning:**

Socialist means the system under which economic system is controlled and regulated by the government so as to ensure welfare and equal opportunity to the people in a society.

The idea of socialism is first introduced by Karl Marx and Fredric Engles in their book, ‘The Communist Manifesto’.

The word socialism means ‘all things to all men’. According to Samuelson, “Socialism refers to the government ownership of the means of production, planning by the government and income distribution”.

The main features of socialist economy are as follows:

**(i) Collective Ownership:**

In socialism, all means of production are owned by the state, i.e., Government, and no individual can hold private property beyond certain limit. Therefore, it is government who utilises these resources in the interest of social welfare.

**(ii) Economic, Social and Political Equality:**

Under socialism, there is almost equality between rich and poor. There is no problem of class struggle.

**(iii) Economic Planning:**

Under socialism, government fixes certain objectives. In order to achieve these objectives, government adopts economic planning. All types of decisions regarding the central problems of an economy are taken in the economic plans. There is a Central Planning Authority, who plans for the economy.

**(iv) No Competition:**

Unlike capitalistic economy, there is no cut throat competition. It means lack of competition as state is the sole entrepreneur.

**(v) Positive Role of Government:**

In socialism, government plays significant role in decision making. Thus, government has complete control over economic activities like distribution, exchange, consumption, investment and foreign trade etc.

**(vi) Work and Wages According to Ability and Needs:**

In socialistic economy, work is according to ability and wage according to need. It is said that under socialism “from each according to his ability to each according to his needs, is socialism.”

**(vi) Maximum Social Welfare:**

The sole objective of socialism is the maximum social welfare of the society. It means that there is no scope of exploitation of labour class. Government keeps a close eye on the needs of the poor masses while formulating plans.

**A socialist economy**

A socialist economy is an economic organisation in which the means of production are owned and regulated by the state. The production and distribution of goods and factors of production are done by the state under the direction of the planning commission.

The decisions as to how much to produce, which methods of production to employ and for whom to produce are taken by the planning authority. That is why a socialist economy is also called a planned economy. Such economies are China, Cuba, Vietnam, and North Korea. They possess the following common features.

**The main features of this system are detailed below.**

**(1) Public Ownership:**

A socialist economy is characterised by public ownership of the means of production and distribution. There is collective ownership whereby all mines, farms, factories, financial institutions, distributing agencies (internal and external trade, shops, stores, etc.), means of transport and communications, etc. are owned, controlled, and regulated by government departments and state corporations. A small private sector also exists in the form of small business units which are carried on in the villages by local artisans for local consumption.

**(2) Central Planning:**

A socialist economy is centrally planned which functions under the direction of a central planning authority. It lays down the various objectives and targets to be achieved during the plan period. Central economic planning means “the making of major economic decisions—what and how much is to be produced, how, when and where it is to be produced, and to whom it is to be allocated—by the conscious decision of a determinate authority, on the basis of a comprehensive survey of the economic system as a whole.”

And the central planning authority organises and utilises the economic resources by deliberate direction and control of the economy for the purpose of achieving definite objectives and targets laid down in the plan during a specified period of time.

**(3) Definite Objectives:**

A socialist economy operates within definite socio-economic objectives. These objectives “may concern aggregate demand, full employment, satisfaction of communal demand, allocation of factors of production, distribution of the national income, the amount of capital accumulation, economic development…and so forth.” For achieving the various objectives laid down in the plan, priorities and bold targets are fixed covering all aspects of the economy.

**(4) Freedom of Consumption:**

Under socialism, consumers’ sovereignty implies that production in state- owned industries is generally governed by the preferences of consumers, and the available commodities are distributed to the consumers at fixed prices through the state-run department stores. Consumers’ sovereignty under socialism is confined to the choice of socially useful commodities.

**(5) Equality of Income Distribution:**

In a socialist economy, there is great equality of income distribution as compared with a free market economy. The elimination of private ownership in the means of production, private capital accumulation, and profit motive under socialism prevent the amassing of large wealth in the hands of a few rich persons. The unearned incomes in the form of rent, interest and profit go to the state which utilises them in providing free education, public health facilities, and social security to the masses. “As far as wages and salaries are concerned, most modern socialists do not aim at complete and rigid equality. It is now generally understood that the maintenance offered choice of occupation implies wage differentials.”

**(6) Planning and the Pricing Process:**

The pricing process under socialism does not operate freely but works under the control and regulation of the central planning authority. There are administered prices which are fixed by the central planning authority. There are also the market prices at which consumer goods are sold. There are also the accountings prices on the basis of which the managers decide about the production of consumer goods and investment goods, and also about the choice of production methods.

**Merits of Socialism:**

Prof. Schumpeter has advanced four arguments in favour of socialism: one. greater economic efficiency; two, welfare due to less inequality; three, absence of monopolistic practices; and four, absence of business fluctuations. We discuss these merits of socialism one by one.

**(1) Greater Economic Efficiency:**

Economic efficiency under socialism is greater than under capitalism. The means of production are controlled and regulated by the central planning authority towards chosen ends. The central planning authority makes an exhaustive survey of resources and utilises them in the most efficient manner.

Increased productivity is secured by avoiding the wastes of competition and by undertaking expensive research and production processes in a coordinated manner. Economic efficiency is also achieved by utilising resources in producing socially useful goods and services which satisfy the basic wants of the people, like cheap food, cloth, and housing.

**(2) Greater Welfare due to Less Inequality of Income:**

In a socialist economy there is less inequality of income as compared with a capitalist economy because of the absence of private ownership of the means of production, private capital accumulation, and private profit. All citizens work for the welfare of the state and each is paid his remuneration according to his ability, education and training. All rents, interests and profits from various sources go to the state which spends them for public welfare in providing free education, cheap and congenial housing, free public health amenities, and social security to the people.

(3) Absence of Monopolistic Practices:

Another advantage of socialism is that it is free from monopolistic practices to be found in a capitalist society. Since under socialism all means of production are owned by the state, both competition and monopoly are eliminated. The exploitation by the monopolistic is absent. Instead of private monopoly, there is the state monopoly of the productive system but this is operated for the welfare of the people. In the state-owned factories, socially useful commodities are produced which are of high quality and are also reasonably priced.

**(4) Absence of Business Fluctuations:**

A socialist economy is free from business fluctuations. There is economic stability because production and consumption of goods and services are regulated by the central planning authority in accordance with the objectives, targets and priorities of the plan. Thus there is neither overproduction nor unemployment.

**Demerits of Socialism:**

A socialist economy has also certain disadvantages:

**1. Loss of Consumers’ Sovereignty:**

There is loss of consumers’ sovereignty in a socialist economy. Consumers do not have the freedom to buy whatever commodities they want. They can consume only those commodities which are available in department stores. Often the quantities which they can buy are fixed by the state.

**2. No Freedom of Occupation:**

There is also no freedom of occupation in such a society. Every person is provided job by the state. But he cannot leave or change it. Even the place of work is allotted by the state. All occupational movements are sanctioned by the state.

**3. Malallocation of Resources:**

Under socialism, there is arbitrary allocation of resources. The central planning authority often commits mistakes in resource allocation because the entire work is done on trial and error basis.

**4. Bureaucratic:**

A socialist economy is said to be a bureaucratic economy. It is operated like a machine. So it does not provide the necessary initiative to the people to work hard. People work due to the fear of higher authorities and not for any personal gain or self-interest.

There is no doubt that a socialist economy is better than a capitalist economy because of its overwhelming merits. But it is disliked for the loss of political, economic and personal freedoms.