Economic Systems—How Many in the Twenty-First Century?

Economic System
The institutions a society establishes to deal with choices imposed on it by scarcity.

As we saw at the outset of our introduction to the study of economic societies, scarcity—the inability to satisfy all human wants with limited resources—imposes on every society the necessity to create institutions that result in choices about how to use those limited resources. As well, decisions about *which* wants to satisfy must be made. These institutions created to bring about these choices are called an **economic system**.

Throughout history, economic systems have competed against one another, both intellectually and politically. Those judged inferior, especially in terms of efficiency and growth, have given way to those judged superior on one or both grounds. In perhaps no period of history was that competition more intense than in the twentieth century. The two main rival systems from the mid to the late twentieth century were planned socialism and market capitalism. We will look at each in turn, but let us first look again at the kinds of choices all societies throughout history have been forced to make because of scarcity.

Basic Economic Choices: A Reminder

Let's remind ourselves of the choices imposed by scarcity. Regardless of the philosophical or ideological preferences of a society, these are the questions about using resources that *must* be answered. By way of quick review, these choices are:

1. *What* shall be the composition of output? Since everything that is desirable cannot be produced in the quantities desired, choices, often difficult ones—must somehow be made about allocating resources to produce one good as opposed to another. Shall these choices be made by individual consumers or shall government planners make the decisions? Whose tastes and preferences, in other words, shall dominate the choice about output?

2. *How* shall goods be produced? At any particular time, there is a menu of choices about producing goods. Shall we, for example, produce information for making economic decisions with typewriters and telephones or with computer hardware and software? An answer to this question is necessary; shall it come from individual managers and entrepreneurs or from central planners?

3. *Who* shall receive the output (real income) of the society? This question of distribution is perhaps the most difficult and potentially divisive one for all nations. Shall markets, responding to productivity signals, ration output on the basis of (market-earned) incomes and tastes or shall planners set prices and factor incomes according to some set of "social" objectives? What is equitable or fair? Since, as we have noted at various points, there is no unique definition of distributive equity, each society must not only find a means or process to distribute income, but must also agree on the results of that process.

Evaluating an Economic System

There are many dimensions to the evaluation of an economic system and economic, along with moral and political criteria may be used. An economic criterion inevitably used is that of efficiency in resource usage. Rich society or poor, socialist or capitalist, the ability to provide solutions to economic problems now and in the future depends heavily on efficiency. We shall look at efficiency questions in two dimensions.

Static Efficiency
At a point in time, using resources in ways that produce the most desired mix of output.

Static Efficiency

Since resources are scarce, they must, to be used efficiently, be allocated to produce that mix of goods and services that the society prefers. While the answer to what is preferred depends on whose preferences are considered, no society in a static (timeless) sense is efficient if it produces one good (for example, pet rocks) where doing so causes it to produce less of another good (microcomputers for example) that is more preferred.

Dynamic Efficiency
Over a period of time, using resources in ways that maximize the long-term benefits from their employment.

Dynamic Efficiency

Dynamics involves looking at a process over time. Present uses of resources will have consequences for the future and for future consumers. Efficiency over time requires that scarce resources be used in ways that maximize the stream of long-term benefits from their employment.

Whether from the standpoint of static or of dynamic efficiency, the successful use of resources critically involves control over those resources or, in other words, the location and security of property rights.

Property Rights: Should They be Vested in Individuals or in the State?

Property Rights
The rights to own, control, and profit from the use of resources.

Property rights, the rights to own, control, and profit from the use of resources, must be vested somewhere in any society. Without property rights and the control they carry with them, choices about resource usage would be impossible. There are two basic ways these rights may be assigned in an economic system:

Private Property Rights

Property rights in resources may be assigned exclusively to individuals who not only control their use but also have the right to transfer control to others through a process of exchange. In such a system, the individual owns not only his own labor, but also any other real or financial assets to which title is held. Homes and land, for example, are owned by individuals and families who are free to sell them, rent them, or make any other lawful use of them.

Public Property Rights

Public property rights are not assigned to individuals but are held in some kind of communal ownership. Though individuals own their own labor, other resources including land and housing are not individually owned and cannot, therefore, be sold or rented to others by their occupants. Collective problems now and in the future depends heavily on efficiency. We shall look at efficiency questions in two dimensions.

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Public Property Rights

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No society today assigns property rights entirely in one way or the other. In the U.S. there are some goods such as parks as well as many schools that are collectively owned. There are also public goods such as military weapons that have indivisible benefits. In the former Soviet Union, there were some goods, such as automobiles, that were privately owned, and much agricultural output came from privately controlled plots of land. In addition, there was a large informal or "underground" economy. Still, each present society has a *emphasis* about the location of property rights with some such as the United States emphasizing private property rights and others such as Cuba emphasizing public property rights.

Why Do Property Rights Matter?

Property rights are important to an economy in two separate but interrelated ways. To begin with, such rights or their lack, create incentives or disincentives on the part of individuals to supply effort and to create innovations. If I do not own the home in which I live, what incentive have I to keep it up or improve it? If I cannot patent a new process, what incentive have I to develop it? A society with secure widespread private property rights is, therefore, one in which individuals will be likely to supply effort voluntarily and one in which innovation is likely to be forthcoming.

Property rights also heavily influence the distribution of income in a society. Those who own more resources or more productive kinds of resources will be likely to receive a greater part of the income and real product of the economy. If individuals such as inventors or innovators are given exclusive use to their new processes, they will enjoy monopoly returns and incomes. If, on the other hand, individuals are completely denied such ownership rights, disincentives to effort and innovation are created. Trade-offs, thus, are created in all societies when property rights choices are made.

Housing may well be one of the best examples of these trade-offs. If privately owned, incentives exist to maintain and improve it. At the same time, the best housing will go to those with the most income, while those with lesser incomes will have less desirable housing. Some may actually be homeless. If housing is publicly owned, disincentives exist for individuals to maintain and improve it but there may be more widespread access to it (assuming enough of it is produced).

With this background in mind, let us turn to look at each of the two major twentieth century benchmark economic systems—market capitalism and planned socialism—in turn. First, we will examine market capitalism, a system whose detail has been examined throughout this book. Now,

MARKET CAPITALISM

Market Capitalism
An economic system characterized by (1) private assignment of property rights and (2) decision making about uses of resources is expressed through a system of product and factor markets.

A system of **market capitalism** has two *essential criteria*:

1. Most of the means of production are privately owned. Property rights are vested in individuals. As a result, economic decision making is relatively decentralized, and

2. Economic decisions about uses of resources are expressed through a system of interrelated product and factor markets.

By private ownership of the means of production, we mean that the legal owners of real capital (machines, buildings, and so on) used to produce goods and services in an economy are *individuals* in that society. This definition allows for the existence of corporations, since they are owned by stockholders. In addition, it allows for some government ownership. But the amount of capital owned by the government is a small percentage of the total means of production. The fact that, in the U.S., governments own some schools, hospitals, parks, and so on, does not, therefore, mean the U.S. economy is not *capitalist*.

Markets in a capitalist economy may be organized in many ways ranging from highly competitive to monopolistic in structure. The key feature of capitalism, though, is not the structure of these markets, but the fact that *markets exist*. Market capitalism is not necessarily the same thing as a competitive-free-enterprise market system. Nor, in the political realm, does capitalism *necessarily* translate into a representative, democratic system of government. We will come back to this point later.

Necessary Legal Features of Market Capitalism:
(1) right of private ownership, (2) legal enforceability of contracts.

For a capitalist economy to function well, two **necessary legal features of market capitalism** must exist. The two basic elements of this legal framework are (1) *the right of private ownership or, in other words, secure private property rights* and (2) *the legal enforceability of contracts*.

Economic Advantages of Market Capitalism

Because choices about what to produce and what to buy are made by private individuals, choice making under capitalism, as we noted, is relatively decentralized. This is true even in a capitalist economy in which significant elements of monopoly may exist in product and factor markets. Voluntary exchange based upon mutual advantage is perhaps the most important distinguishing characteristic of capitalism. The role of government in such an economic system, while important, is relatively limited.

As noted before, a principal advantage of a capitalist economy lies in the incentives to efficiency created by private property rights.

Free Riders
Individuals who can lay claim to the benefits of using resources while bearing none of the costs of their usage.

Because private owners of resources keep the gains of their use and have the right to sell their property, there is a strong incentive to maximize the value of those rights by using resources efficiently. Those who take risks receive whatever profit is created; to use the term economists prefer. there are no "**free riders**," individuals who can lay claim to the benefits from resource usage for which they bore none of the costs.

A second advantage of capitalism is that the costs of decision making are likely to be low relative to societies without private property rights. The administrative costs of firms and private decision makers in general may be sizable but there is an incentive to minimize them since profit is the residual after subtracting costs from revenue flows. In a centrally planned economy, on the other hand, the planning mechanism must be relatively large and costly. Those who manage it have less clear incentives to minimize its costs since they have no property rights in the resources and must share any productive gains with numerous "free riders."

Economic Criticisms of Capitalism

Even though a capitalistic system allocates resources with efficiency, its critics argue that it has two drawbacks:

1. The tastes of some consumers, those with greater incomes: are given more weight than those of others in determining what to produce. Output is rationed, therefore, on the basis of how much money each consumer has to spend. For those in poverty, who have needs but less purchasing power, the market does not readily supply goods. These output results trouble those who regard them as inequitable and frequently lead to arguments in capitalist societies "for income transfer programs."

2. Business firms, in setting output and prices, fail to include in their calculations the external costs (and benefits) that result from production but that are not part of the private costs or benefits of production or consumption. The most notable of these external costs are pollution and other forms of damage to the environment. *Note:* Socialist countries are by no means untarnished in this respect. The same kinds of externalities appear to occur in socialist economies such as the former Soviet Union as was seen in the nuclear plant disaster at Chernobyl in 1987 and in the pollution of many of that nation's major lakes and waterways.

In order to deal with the problems of poverty and ecological damage, societies—often acting through governments—must devise means of interfering with or supplementing market decisions. Inevitably, such interferences involve abridgments of private property rights.

Because of the diversity of socialist theory, it is difficult to give a precise definition of socialism that can encompass all its forms. Here we will describe the most important one in modern times: all forms of planned socialism.

What is Planned Socialism?

Planned Socialism
An economic system in which property rights are largely held publicly and choices about resource usage are made by central planners.

Of the many varieties of socialism found in the late 20th century, **planned socialism** is the one with most direct ties to Marxist thought. Property rights are largely held publicly and choices about resource usage are made centrally by a group of planners. If one created a spectrum of economic systems, this one would be at the opposite end in terms of resource decisions and rewards from the pure form of market capitalism discussed earlier.

Advantages of Planned Socialism

Unlike the results of pure capitalism, planners in socialism can create any distribution of real income desired. By allocating resources and by setting prices, all distributional "inequities," at least in theory, can be eliminated. By planning, all externalities (theoretically) can be incorporated into those prices and resource allocations.

Criticisms of Planned Socialism The major disadvantage of planned socialism is that with public property rights, there are, as indicated earlier, disincentives to individual effort. If all laborers, for example, are to be paid the same, why would one work harder than any other? Distribution, in other words, can be made more "equitable," but there may be less to distribute since productivity differentials are not rewarded. The second major disadvantage of planned socialism is more technical. Since there are no private markets to guide the allocation of resources (no "market tests"), how do the planners figure out where financial capital and other resources should go? All must be done by plan, an enormously more difficult and costly task than the "invisible hand" direction of capitalism. If to this is added the fact that managers who actually produce goods are given quotas, the incentives to quality as opposed to quantity may be low as well. Resource wasteage may be high.

Marx and Socialism

Just as Adam Smith created much of the foundation for capitalist thought, Karl Marx is responsible for the foundation of planned socialism. Marx's theory of history sought to explain the evolution of socialism and, for that reason, we will briefly examine the principles he set forth. This is true even though Marx wrote mostly about Capitalism rather than socialism. Indeed, his most important work, *Das Kapital*, is an analysis of capitalism and a forecast by Marx of its ultimate demise.

Dialectical Materialism

Dialectical Materialism
A view that material things are the subject of all change and that technology, and the natural environment are the causes of that change.

The philosophical foundation of Marxism is **dialectical materialism**, a philosophy that views material things as the subject of all change and technology, and the natural environment as the main forces that cause human society to change continually. Let's examine this philosophy one step at a time.

Dialectics emphasizes that all phenomena, natural and human, involve processes of development. The seed grows into the plant. The infant grows into the child, the child into the youth, the youth into the adult. (Darwin's theory of evolution is another example of this dialectical process of reasoning.)

Marx analyzed this process of development of human society, and used it, as he came to understand it, as the scientific basis for socialism. The first law of this argument is that the foundation of society is materialistic. Technology and the natural environment (climate, resources, geography) are the dominant forces in society's development. The rest (culture, institutions, social classes, and the relations between them) are linked to the economic (materialist) base, and are shaped by that base.

Historical Materialism
The view that human society undergoes a continual process of change from one form to another.

Dialectical materialism is the basic idea behind Marx's concept of **historical materialism**, which holds that human society throughout history has undergone a continual process of change, or development from one form to another: this change results from conflict between classes in a society. In ancient times, there was slavery; in medieval times, serfdom; then came handicraft and cottage industry, which gave way to factory-oriented capitalism. The guiding factors in this process are changing technology and the natural environment.

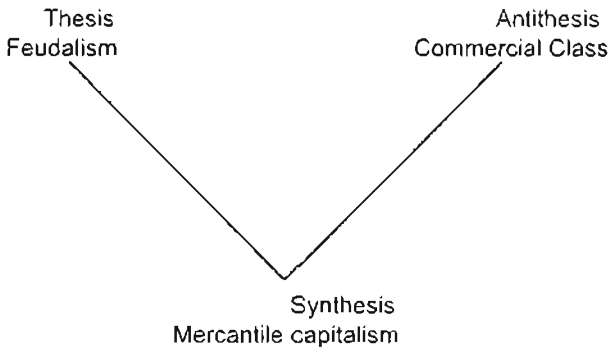
Figure 18-1 illustrates this process of social change or class conflict for the transition from feudalism to the beginnings of capitalism. The *thesis* (the class system that is dominant at a given time) is feudalism, in which the ruling class is the landed aristocracy. The *antithesis* (the class that is the main force in changing the thesis) is the emerging commercial class. The *synthesis* (the system that evolves after the antithesis has forced changes) is mercantile capitalism, in which the commercial class replaces the landed aristocracy as the dominant class.

Class Conflict

Marx, as we indicated before, believed that the most dramatic feature of this process of change was the conflict of classes at each stage of development.

In ancient Rome, the slaves were in conflict with their masters. In medieval Europe, the serfs and the emerging merchant class were in conflict with the landed aristocracy. With

Figure 18-1
An Example of Marxian Analysis



Another example would be: thesis = industrial capitalism; antithesis = the proletariat, or laboring class; synthesis (what Marx predicted would occur) = socialism.

Labor Theory of Value
The Marxist argument that the entire value of a product is made up of its labor cost.

Surplus Value
In Marxist theory, the difference between the value created by labor and its wage payments.

the development of factories, a new class, the *proletariat* (the workers in the factories), came into conflict with the capitalists, the owners of the factories. The basis of these conflicts is the effort of one class to dominate and exploit other classes. A basic tenet of Marxism is that as long as there are private property rights classes will continue to exist, and conflict will result. Marx argued for a **labor theory of value**, that is that all value is created by labor, but that wages under capitalism tend toward a subsistence level. The difference between the value of products created by labor and the wage payments to labor constituted what Marx called **surplus value**.

Falling Profits and the Reserve Army of the Unemployed

According to Marx, competition between firms and the increasing scarcity of profitable investment opportunities would cause profits in a capitalist economy to fall. Capitalists could counter this fall in two ways: (1) They could get employees to work longer hours, and in this way increase surplus value and the degree of exploitation of labor. But the opportunity to do this was limited. (2) They could invest more and improve technology further, thus increasing output per worker and surplus value. However, improving technology meant that more and more machines replaced more and more workers, and this increased unemployment.

Reserve Army of the Unemployed
Marxist idea that capitalist societies displace labor in favor of capital and create a growing number of unemployed workers.

The rising number of unemployed caused by increased use of capital and improved technology was called the **reserve army of the unemployed**. This reserve army, Marx said, competed with the employed workers, and this competition had the effect of keeping wages down.

Recurring Business Cycles

Marx also maintained that as capitalists increase investment to ward off falling profits, the productive capacity of the economy expands and output increases. But because wages are kept low, workers do not have the ability to buy this expanded output. So, although the economy expands for a while, eventually industry's ability to produce output far outstrips consumers' ability to buy that growing output. (If you tool up your factory with all the latest equipment, so that you can make 10,000 washing machines a month, but the public has enough purchasing power to buy only 5,000 of them, you will eventually go broke.) Excess capacity is generated, which causes economic crisis and then collapse. Along comes a depression, and firms are forced out of business. Eventually, enough firms are forced out of business so that capacity contracts to a point at which expansion can be renewed, and the process repeats itself. Marx identified the business cycle and the exploitation of labor as the two hallmarks of the capitalist system. Marx was one of the first to introduce the idea of recurring business cycles, and his theory of them constituted a significant contribution to economic theory.

Marx's Prediction: The Collapse of Capitalism

Marx concluded that capitalism (the thesis) contained within it inherent contradictions (capitalism's antithesis) that would bring about its end and a movement toward the next stage of development, socialism. He predicted that economic crises would recur, and would become progressively more serious. With more investment and continuing technological change, the reserve army of the unemployed would become larger and larger. Because of their increased investment and ever-greater need to compete against others, firms would get bigger. As this occurred, those among the bourgeoisie who owned smaller firms would be forced into the proletariat and into the reserve army of the unemployed.

Eventually, Marx predicted, economic crisis and unemployment would become so large that revolution would take place, and capitalism would be overthrown. The proletariat would come to realize that capitalism was against their self-interest; the wastes of resources due to recurring crises would become apparent. The proletariat would therefore seize political power and establish a socialist society which would ultimately

What Happened to the Collapse?

Marx argued that the overthrow of capitalism would take place in the most advanced countries. Marxist socialism, however, was established almost entirely in economically backward societies. In addition, in the late 20th century, many Marxist economies have moved toward the establishment or reestablishment of capitalist economic institutions. Has history proved Marx wrong?

Whether the Marxist prediction would have ever been fulfilled had capitalist economies remained unchanged is unclear. What is evident is that since Marx's prophesy, there have been four fundamental influences at work in capitalist societies that have increased their vitality and made their predicted collapse fundamentally wrong.

1. Contrary to the labor theory of value, labor's wage depends, in a market economy, on its productivity. As more capital is employed, labor's productivity rises as does its wage. Indeed, labor's (wage-salary) share of national income, at least in the U.S., has grown to 60 to 70 percent and has been remarkably steady since World War II. The Marxist view of increasing exploitation seems unwarranted. The very (labor) theory of value on which it was based has been repudiated.

2. Since the 1930s, governments in market economies have taken an active role in trying to stabilize their economies. To many economists, this seems to have reduced the severity of recurring business crises. Also, it is not at all clear that crises in such economies were becoming ever more severe.

3. Modern capitalist states have developed extensive social welfare programs to redistribute real income. Whatever its growth effects and incentive effects, redistribution is seen by some as having taken the "sting" out of pure market capitalism.

4. Many workers have themselves become capitalists in a small way. In the U.S., 67 percent of the population either own or are buying their own homes, and about 40 percent own stocks or bonds, either as individuals or through pension and retirement funds. In other words, larger numbers of workers are sharing in the property rights of capitalism.

Efficiency of Central Planning: The "Fatal Conceit" Problem

Over time, centrally planned economies in the twentieth century ultimately seem to have suffered from "economic sclerosis." Some of these economies, especially that of the Soviet Union, experienced substantial growth during periods in which they were building basic industries such as steel. As they matured, however, an inability to reallocate resources to their most productive uses became increasingly severe. As we know, in market economies, this process of reallocation depends on a myriad of changing supply and demand signals that emanate from both consumers and producers. The market pricing system, thus, provides generally reliable information to resource owners about the most profitable uses of those resources in the face of changing consumer tastes as well as changing technology.

In a centrally planned economy, on the other hand, such flows of information do not "bubble up" from the interaction of buyers and sellers. Rather, central planners, in deciding on uses of resources, their prices, and the prices of both producer and consumer goods must try to estimate all that information. A Nobel Laureate, Frederick Hayek, referred to the presumption by planners that they could generate and efficiently use this information without allowing markets to exist as the "fatal conceit" of centrally planned economies. It led Hayek to conclude that, ultimately, centrally planned economies would grow less and less efficient and would fail. This remarkable insight by Hayek occurred decades before the collapse of the Soviet Union.

The End of Planned Socialism?

Ironically for Marxists, by the late 1980s, it was the planned socialist states that were on the brink of collapse. In the amazingly brief period of less than a decade following 1989, the Soviet Union collapsed (1991) and split into ten independent republics, most of which moved in varying degrees to try to create capitalist economies. In addition, all the planned socialist states of Eastern Europe moved to recreate capitalist economies with Eastern Germany becoming a part of a reunited German capitalist society. In Asia, in the 1980s, China, the world's most populous society, began a steady movement toward a capitalist economy. While proclaiming its devotion to socialism, the nation began basic economic reform first in agriculture where private property rights were restored and then to create private firms and private stock ownership throughout special economic zones. In 1997, a decision was made to either privatize or close many of the huge, inefficient state-owned firms in basic and consumer goods industries. As we enter the twenty-first century, there are few economic societies left that can be called planned socialist. North Korea and Cuba are two that cling to a rejection of markets in favor of central planning, Even Cuba, though, is experimenting with limited market reforms though seeking to find ways to do so while maintaining its commitment to a socialist economy.

Has history proved Marx wrong? Impressive evidence suggests that the answer is Yes. In recent years, some writers have argued that we are witnessing an "end to history," a termination of the contest among competing economic systems. We are skeptical of this argument, for systems evolve and the future, by definition, is unknown. What seems clear at the end of the twentieth century, however, is that the contest between economic systems based on markets and those based on central planning has been resolved in favor of markets.

Transition from Planned Socialism to Market Capitalism: How Long and How Difficult?

Major questions exist about how to accomplish a transition from planned socialism to market capitalism and about the length of time required for such a transition. Even in Eastern Europe, which had market economies until the 1940s, major problems of transition occurred. While it might seem relatively simple to privatize a socialist economy, in fact, it has proved complex even in Poland, whose pace of reform has been among the most rapid in the region.

Key Reforms

There is no simple "recipe" of reforms in the transition from planned socialism to market capitalism. Nonetheless, there is widespread agreement, based especially on the experience of Eastern Europe, that among the most important key reforms are:

1. Creation of private property with secure property rights

2. Creation of a system of prices that reflect relative scarcity

3. A monetary system that permits price stability and the achievement of the price goals in (2) above

4. A system of institutions, both economic and political, that facilitates the first three reforms

Command Economy
An economy in which the problems created by scarcity are dealt with by a central planning bureaucracy.

Market Economy
An economy in which the problems created by scarcity are dealt with by market signals that allocate and reallocate resources.

Let's look at each of these four interrelated reforms to see why they form a package of changes necessary to transform a **command economy**—*one in which the problems created by scarcity are dealt with by a central planning bureaucracy* into a **market economy**—*one in which the problems arising from scarcity are dealt with by market signals.* These signals allocate and reallocate resources to their (changing) most productive uses.

Secure Private Property Rights

A key feature of a market economy is the ability of private individuals—acting on the incentive to maximize the value of their property rights—to choose how to use resources, including financial capital, under their control. As we said before, secure private property rights minimize free rider problems and permit an expectation on the part of property owners that they will be able to appropriate the benefits of their maximizing efforts. Under planned socialism, this type of private gain was officially discouraged, if not prohibited. Today, in some former socialist states, especially the former Soviet Union, private property rights remain restricted. As an example, Russia has yet to permit unrestricted private ownership of land. Partially, as a result, agriculture remains a major problem in terms of productivity.

Prices that Reflect Relative Scarcity

Under planned socialism, prices were set by central planners to accomplish "social" objectives. Heavily subsidized prices, particularly of basic staples such as bread, electricity and housing were seen as "equitable." The two main problems that resulted, however, were that (1) not nearly enough of the goods were produced to clear markets, thus creating unfilled demand (long waiting lines, in many cases), and (2) the distorted prices created perverse incentives to use goods that were produced. As an example, in the 1980s, administered bread prices were so low in Poland that farmers reportedly fed bread, rather than more expensive grain, to their cattle and hogs! Many formerly socialist states have reformed prices (it was a first action of the democratic Polish government in 1990), but Russia has yet to undertake the politically painful rationalization of its entire pricing system.

A Monetary System that Permits Price Stability

Price reform and monetary reform go hand in hand. When prices are reformed and subsidies eliminated, governments in newly-forming market economies are tempted to expand the money supply to "take some of the sting" out of price reform. The result in Russia in the mid 1990s, for example, was an inflation rate of over 1,000 percent per year. A currency of determinate and stable value is also necessary for foreign trade and as an incentive to attract long-term foreign capital to the former socialist states. Still, the temptation to ease the pain of price reform with increased supplies of money is intense. Russia's central bank announced in 1999 that it planned to do just that.

Institutional Reform

The economic and political institutions created by a society are nothing less than the set of means by which all economic activities are governed. These institutions determine the cost of economic transactions. If the institutions are reliable and efficient, the volume of transactions increases and the size of the economy is enhanced. If the institutions are unreliable and inefficient, the reverse happens and economic growth slows. Where institutions are unreliable, economic activities are subject to corruption and many are diverted to an "underground economy." The institutions created by long-standing market economies took long to create. It remains to be seen whether they can easily be transferred to some formerly planned socialist economies. This is especially true of such economies that had never been fully evolved market societies.

Mixed Economies: A Third System?

Mixed Economies
Economic systems that combine elements of private and public property rights and centralized as well as decentralized choices about resource usage.

There is no economy in the late 20th century that falls neatly into one of the two systems that we have outlined. Private property rights are dominant in some, public property rights in others; almost all have a mixture of the two assignment methods. In some economies choices about using resources are very decentralized; in others, central planning of those choices continues; in almost all there is some mixture of these levels. Nations at this time are, thus, **mixed economies**, those that combine elements of private and public property rights along with centralized as well as decentralized choice making about resources.

Many Western European economies have evolved what is known as *democratic socialism.* Sweden, Belgium and other economies come to mind. One may question whether such modern "welfare states" are really a distinct economic system. Almost all, though, rely, in practice, on private property rights to create incentives for resource usage while permitting decentralized private markets to allocate resources. Democratic socialism, in other words, seems more a political than an economic system, one in which the state has distributional goals which it achieves through political means while relying on a decentralized market economy for the resources with which to achieve those goals.

The End of Socialism: A Disclaimer

Does the end of the Cold War mean that capitalism has won out over socialism and that the latter will disappear as an economic system? The argument *has* been advanced that ideological contest and the evolution of economic systems is over. Contrary to Marx's prophecy, say proponents of this view, capitalism has proved to be the ultimately successful economic system. Others, such as the well known American socialist economist, Herbert Gintis, conclude that "reports of the death of socialism are premature." Gintis concedes that "markets work because they are disciplinary devices," thus they avoid shirking, reveal price information and produce high-quality goods under the threat of losing buyers. In turn, managers have incentives to invest in profitable activities and employees incentives to work hard to avoid loss of jobs.

Nonetheless, says Gintis, Eastern Europe (including the Soviet Union) was never the socialism envisioned by its philosophical founders.

Nor, according to Gintis, are modern capitalist economies, the models envisioned by Conservatives because they have "incorporated socialist goals and structures into their institutional fabric." Both systems, he argues, must continue to evolve and incorporate the features of each that have merit.

Economic and Political Freedom: Are They Related?

As planned socialist economies began their transition to market capitalist economies, a question that became common was: *Will the increased freedom associated with capitalism lead to faster growth as well as greater political freedom?* These are, in fact, two *interrelated* questions. One appears to have a fairly clear answer, the other is more arguable.

Faster Growth

Recent studies seem to confirm the view that greater economic freedom is associated with higher levels of GDP and faster growth. In a 1994 study by the *Heritage Foundation*, free and mostly free nations (relatively free of government economic controls), such as Hong Kong, the U.S., and the U.K., dominated the list of nations with high per capita GDP. Mostly unfree and repressed nations, such as Vietnam, Cuba, and N. Korea (all of which remain planned socialist economies), dominated the list of nations with low GDP per capita. GDP growth rates continued this pattern. It would seem, thus, that as economic freedom increases in formerly planned societies, their growth rates will increase. But, will this, in turn, lead to greater political freedom as well?

Political Freedom: Does it Follow from Economic Freedom

In the 1994 article in *The Wall Street Journal*, Kim R. Holmes argues that policy makers have paid inadequate attention to economic freedom while concentrating on political freedom in the movement away from planned socialism. She suggests a change of emphasis not only because "a free economy can lift itself—and its people—out of poverty," but also because "economic freedom is a breeding ground for political freedom." Should we expect, then, that economic liberalization, with its increased freedom of choice, will be accompanied by political liberalization and increased freedom to choose political leaders.

Proponents of this economic-political liberalization argument feel that as consumers and producers exercise economic freedom they will press for freer political choice as well. This is especially true, argue some political scientists, as a middle class develops and grows with faster growth in per capita GDP. Those skeptical of the argument counter that economic and political freedom are not that well correlated. Skeptics point, for example, to Singapore and Hong Kong as examples of high income countries with great economic freedom that have significantly lesser levels of political freedom.

China: A Test Case?

Nowhere has the argument about economic and political freedom crystallized more than in arguments about U.S. economic policy toward the People's Republic of China. Though China still is not among the World's most free economies (it ranked 87 of 101 nations in the 1994 Heritage Foundation Study), it has moved in the 1990s *toward* creation of the requisites of a market economy. Nonetheless, China, at least at the national level, remains politically monolithic. Only the Communist party is permitted to exist. In 1999, dissidents who attempted to form a new political party were imprisoned. Critics of the "economic-freedom-leads-to-political-freedom argument" cite this as evidence, not only of the incorrectness of the argument, but also of the need to change U.S. economic policy toward China. Proponents, on the other hand, point to increased political freedom at local levels in China and argue it will ultimately translate into political liberalization at the national level.

Who is right? At this point, there is no clear answer. In the twenty-first century, however, China may well be the clearest test case of the arguments about the relationship between economic and political freedom.

SUMMING UP

1. An economic system consists of the institutions created by a society to deal with the problems created by scarcity.

2. The basic questions that all economic systems must address because of scarcity are: (a) What to produce, (b) What shall be the technology of production, and (c) Who shall receive the real income of the society.

3. Any economic system can be evaluated in terms of its (a) static efficiency, (does it produce what is desired?), and (b) dynamic efficiency, (are resources used to maximize the long-term stream of benefits from their use?).

4. The placement of the *property rights*, rights to own, transfer and profit from the ownership of resources, may be public or private. All societies have some mix of these two assignment methods.

5. Property rights are important to societies in two ways: (a) they create incentives innovation and (b) they heavily influence the distribution of income.

6. A system based on *market capitalism* has two essential criteria: (a) The means of production are privately owned and property rights are vested in individuals. (b) Economic decisions are expressed through a system of interrelated markets and are decentralized. The two legal features necessary to achieve these essentials are (a) the right of private ownership and (b) the legal enforceability of contracts.

7. Two major economic advantages of market capitalism are (a) the incentives to efficiency by private property owners seeking to maximize the value of their rights along with the absence of *free riders*—those who benefit from using resources but bear none of their cost, and (b) incentives to minimize decision-making costs.

Cartoon Feature Syndicate

"I forget whether he calls himself a conservative radical or a radical conservative."

8. The criticisms of market capitalism are: In a society in which there is pure capitalism, the needs of poor people who have less purchasing power are given less weight in establishing market demand. In addition, firms may fail to consider external costs and benefits, especially the costs to the populace of pollution and other forms of environmental damage. The economic advantages of capitalism

include: (a) the efficiency that private property right incentives creates, and (b) the low costs of decision making that decentralized decision making creates.

9. *Socialism* has various forms but there is a common belief in each that resources other than labor should be socially owned and there should be few private property rights.

10. *Planned socialism* involves public property rights with centralized choices about using resources. Theoretically, it can create any distribution of real income chosen and can incorporate externalities. However, it creates disincentives to efficiency and lacks an appropriate and low-cost way to allocate resources. It is also far from clear that planned socialism in practice leads to the incorporation of externalities.

11. Karl Marx, the intellectual father of modem planned socialism wrote about capitalism and predicted its ultimate demise. *Dialectical materialism*, the basic principle behind Marx's concept of *historical materialism*, holds that human society throughout history has undergone a continual process of change or development. The social structure evolves from one form to another; the guiding factors in this process of evolution are changing technology and the natural environment.

12. It is basic to Marxist thought that as long as there is private ownership of the means of production, there will be differing classes. As long as classes exist, conflict will exist, as one class exploits another.

13. According to Marx, surplus value, the difference between the value of products created by labor and its wage payments will create a problem of inadequate demand for growing output under capitalism. A declining rate of profit will lead to recurrent depression according to Marx.

14. Marx argued that the falling profits would lead capitalists to increase their investment to improve technology, and this in turn would increase unemployment. The result would be a *reserve army of the unemployed*, with the effect of keeping wages down.

15. Because Marx based his theory of value on labor, he failed to see that labors' payment depends on its productivity. As more capital, and other factors are used that productivity rises and so does labor income; He also failed to foresee that (a) governments in market economies, would step into the picture and reduce the severity of business cycles by manipulating interest rates, taxes, and government spending. (b) that modern capitalist states would develop extensive social welfare programs and, (c) that many workers would themselves become capitalists, through ownership of property or stocks and bonds.

16. Most economies today are mixed economies. They involve various mixes of property rights and levels of resource usage decision making. *Democratic socialism* seems to be a system in which private property rights exist but in which states

intervene after decentralized choices about resource usage are made to achieve distributional goals.

17. Over time, planned socialist economies suffered from the "problem of fatal conceit," a term of Frederick Hayek. Hayek predicted the ultimate failure of such economies because of their inability to generate the information necessary to reallocate resources in the face of changing tastes and technology.

18. By the late 1980s, planned socialist economies began to fail. Many, including the former Soviet Union and the People's Republic of China, began to create or recreate market capitalist institutions.

19. In the 20th century contest between market capitalism and planned socialism, it appears that planned socialism has lost out.

20. The four main reforms necessary in the transition from planned socialism to market capitalism are (a) creation of secure private property rights, (b) creation of a system of prices that reflect relative scarcity, (c) a monetary system that produces price stability and relative scarcity prices, and (d) political and economic institutions that facilitate (a), (b), and (c).

21. Arguments continue about the relationship between economic freedom and political freedom. Some argue that in the transition from planned socialism to market capitalism the greater economic freedom of capitalism will engender greater political freedom. Studies indicate that economically freer societies grow more rapidly than planned societies. Arguments continue about whether greater political freedom will accompany increased economic liberalization.

22. Arguments remain about the continuing viability of socialism in the post-cold war era. Some conclude that ideological evolution has ended and that capitalism has been proved the only viable economic system. Others, such as Herbert Gintis, argue that a new socialism true to its intellectual origins will evolve and that each system will adopt the best features of the other.

QUESTIONS

1. What is an economic system?

2. As a reminder, what choices *must* any economic system create answers to? Why must it do so?

3. As a student of economics, what arguments would you advance for market capitalism as a desirable economic system?

4. What is *planned socialism*? What are its main differences from market capitalism?

5. Sketch the main points of Marx's model of history and explain why Marx's prediction about the collapse of capitalism has not come true.

6. What is meant by the Marxist term, "surplus value"? What is the labor theory of value on which it was based?

7. How is the "free rider" problem resolved in a market capitalist economy?

8. Why do property rights and the level at which choices about using resources occur matter to an economic society?

9. What seems to be the explanation for the fact that most economies in the late 20th century are "mixed economies"?

10. What is the problem of "fatal conceit" that has afflicted planned socialist economies in the 20th century? What causes the problem?

11. Why has planned socialism largely lost out in the contest with market capitalism?

12. What are the major reforms necessary in the transition from planned socialism to market capitalism?

13. What is the argument of Herbert Gintis about the future of socialism?