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LECTURE 02: ECONOMIC SYSTEMS

I. Capital
   a. *Capital* is a type of asset which is used to create goods or services. Buildings, computers, machinery, trucks, and land are examples.
   b. *Capital* is a type of *durable* good, or a good used for at least three years. It's a good you use over and over again. A car is a durable good; the gas for the car is not.
   c. Note that capital is both durable and used to make money (making goods and services).

II. The Market System, or Capitalism
   a. *Capital (and non-capital) assets are privately owned.*
      i. Private ownership—of both capital and non-capital—is the definitive quality of capitalism. (We emphasize capital assets because that's what the debate often gravitates towards, but capitalism desires other things to also be privately owned.) But to make it happen, other things have to happen as well:
   b. <u>Property rights are clearly defined.</u>
      i. If there is question concerning what is owned, then ownership is not really there.
   c. <u>Property rights are strictly enforced.</u>
      i. Ownership is meaningless if someone can steal property without punishment.
   d. <u>Owners collect any profit and suffer any loss.</u>
      i. This is the incentive for capitalists to not only make use of their property (and the risk of investment) but also to use it in a rational way.
      ii. Market prices and freedom of choice coordinate activity.
   e. Is slavery compatible with capitalism?

III. Socialism
   a. *Capital (and non-capital) assets are publicly owned.*
      i. This is the key aspect of socialism. The state (central government) owns the means of production. Thus it has the authority to determine what is made, how much is made, where it's made, who makes it, and when it's made.
      ii. Economic decisions are determined by a central planning board which, in theory, allocates resources based on social priorities.

The slogan “from each according to their ability and to each according to their need” captures this romantic goal. However, this system does not work.

b. The Incentive Problem
    i. It is difficult to reward state planners for doing serving the people well.
c. The Knowledge Problem
    i. It is difficult for state planners to know the best way to allocate resources.
d. Because this system has fundamental flaws, there has never been a pure socialist system. Even North Korea tolerates some market activity and private property from its citizens.
e. Note that socialism is different from communism.
    i. In socialism, the state controls all/most property.
    ii. In communism, *there is no property*. Everything is “owned” communally.
        1. In theory people use the means of production to help others. They don’t shirk their duties or favor one kind of person over another.
        2. If you think this is silly keep in mind this is how the family unit works. No one “owns” the living room TV but its use is allocated without market transactions. Parents don’t love one child more than another.[1]
        3. But people don’t think of strangers the same way as their friends or family. In practice a communist system would require the threat of force to ensure people don’t try to live at the expense of others. The communist system would resemble socialism, which is one reason why some say there is no difference between them.

IV. Free-Market Capitalism

a. Prices are set by the *market*, or the voluntary and mutual exchange between at least one buyer and at least one seller. Supply and demand meet, agreeing on a price.
    i. Voluntary exchange is crucial as that freedom of choice enables individuals to use their property (time, labor, capital) as they see fit.

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[1] I remember hearing about research that suggests most parents have a favorite child. But even if true the less-liked child will be treated much better than a stranger. Asymmetries of affection between offspring, to the extent they exist, are usually subtle.

ii. This in turn implies there’s <u>competition</u>. Not only does competition allow consumers choices (and thus each purchase is truly voluntary and not “buy or die”), but it is often the result of people choosing to enter any line of work they please.

b. Involvement by the state (i.e. government) is small (but not zero).[2] Its main role is to establish and protect property rights through avenues such as police and courts.

V. Crony Capitalism

a. On the surface, crony capitalism is identical to free-market capitalism: private hands own and run most firms.

b. But such firms are also supported by the government in various ways including lax regulations, legal barriers to entry, tax breaks, subsidies, and other sources.

i. <u>Example</u>. Many jobs in the United States require government permission in the form of licensing. It often requires years of schooling, capital investments, and a certain amount of experience. On the surface, it claims to ensure high quality but its ultimate goal is to constrain competition.

c. Profits flow into private hands (and, indirectly, to the hands of bureaucrats and other significant political actors).

VI. Relevance

a. This is particularly important distinction that evades many. Policies that help businesses do not necessarily result in a better economy. Just because the stock market rises or falls doesn’t mean the livelihood of the people are doing better or worse.

b. When judging the quality of a policy, the question often hinges on if the policy would increase or decrease competition. Many pro-business but not pro-market policies make it harder to compete. This is good for incumbent firms but, clearly, not good for society as a whole.

c. What makes crony capitalism particularly difficult to detect is that these kinds of interventions are often framed as having a welfare-enhancing function.

i. <u>Example</u>. Licensing requirements are often framed as protecting consumers from low quality service. Maybe they do. But those requirements also make it hard to start a new business, creating higher prices.

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[2] Zero involvement would imply no government at all. This approach—anarcho-capitalism—suggests everything (police, courts, school system, roads) be handled by private hands.

ii. Example. Many regulations are actually desirable for large companies because such firms can absorb the cost of regulation easier than a smaller company.

iii. Example. Preventing people from abroad selling to domestic consumers is often framed as helping locals get jobs. But it also protects domestic firms from competition and raises prices for everyone.

d. Why do politicians and other political actors tolerate, and even make, these rules? The short answer is that they have interests and incentives unconnected to the benefit of society as a whole. But we'll explore this idea in more detail when we cover public choice in Unit 3.