

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. 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 serving the people well.
 - c. The Knowledge Problem
 - i. It is difficult for state planners to know the best way to allocate resources.
 - d. Socialism doesn't work because it can't overcome these problems; as evidence, all economically rich countries have low levels of socialism. While countries like Denmark and Sweden have generous welfare systems, [they are fundamentally market economies](#).
 - 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 economists typically treat these terms as interchangeable.

III. Capitalism

- a. *Capital (and non-capital) assets are privately owned.*
- b. 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.)
- c. Under private ownership, decisions about production is decentralized. Each producer makes decisions about how much to produce, when to produce it, the quality to produce it at, whom to hire, etc. With all this discretion, how does a capitalist system coordinate?
- d. *Market prices.* Market prices solve both problems socialism struggles with. The price for a good or service is *information*—it informs us how scarce something is—and it’s an *incentive*—when prices change, then behavior changes.
 - i. Imagine the price of cheese increases and imagine that people don’t know why it’s increasing. *Even in their ignorance* as to the cause of higher cheese prices, they will know the most relevant fact: how much scarcer cheese is becoming.
 - ii. People who eat cheese will eat less cheese for the obvious reason that cheese is more expensive. This is desirable: if cheese is scarcer, we want people who value the cheese the least to not consume what’s there. The people who value cheese the least are the most likely to see those higher prices and decide it’s not worth it. And the greater the price change, the greater the adjustment in consumption.
 - iii. People who make cheese will have an incentive to make more cheese for the obvious reason that it’s more profitable to sell.

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.

This is desirable; if cheese is getting scarcer, we want resources, like milk and effort, reallocated to making cheese. Their other uses, like yogurt and ice cream, are now less valuable uses for milk. And, again, the greater the price change, the greater the adjustment in production.

- iv. And so the great economic miracle. Resources are allocated efficiently (though not necessarily “fairly”) without a central planner. We live in a world of unprecedented abundance and no one is in charge!