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TOPIC 04: 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 (by making goods and services).

II. Two problems
   a. Both socialism and capitalism propose different ways of allocating scarce resources. Before defining the difference between these systems, we must first recognize that for *any* system—from a country's entire economy to a single household—to efficiently allocate scarce resources), it must overcome two problems.
   b. <u>The Knowledge Problem</u>. How do you figure out the best use of a resource? How valuable is what you're trying to do? What else could be done with the resources you're using? What other resources could you use to accomplish what you're trying to do? There are substitutes, and there are substitutes for substitutes and it gets complex quickly. That the relevant knowledge is so dispersed, changing, and often hard to articulate makes this such a big problem.
   c. <u>The Incentive Problem</u>. How do you get people to work, and to work well? How do you prevent shirking and corruption and outright theft? In short, how do you get people to use resources efficiently?

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 some kind of 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 accomplish what it sets out to do, nor does it allocate resources efficiently. It does not work.

b. Socialism doesn't allocate resources well because it can't overcome the twin problems of knowledge and incentives.
    i. The Edpuzzle on food banks illustrate the knowledge problem well. Distributing donated food is a relatively simple task, but a central planning system regularly fails to consider all the relevant knowledge, in part because there is so much of it and in part because it's always changing.
    ii. The incentive problem wasn't really a factor in the Edpuzzle because so many people who work for the food bank are going to be motivated to do a good job, but there are not many people like that and there are not many jobs that so cleanly translate into helping people. In socialist economies, the incentive problem is massive. On the management level, people redirect resources from the common good to what benefits them personally. On the worker level there's a strong incentive to shirk or prioritize government loyalty over wise use of resources, depending on the exact nature of the incentive structure.
c. 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.

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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.

IV. 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 are 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. Critically, there's alignment between these two forces—we <u>learn</u> how scarce something is and our <u>actions</u> reflect that scarcity.

   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. <u>This is desirable</u>: 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. <u>This is desirable</u>; 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. What will consumers eat instead of cheese? What items will not be made because we are making more cheese? It's impossible for any one person to know but prices will guide the actions of millions of buyers and sellers to the efficient outcome.

   v. 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!

e. This is why all economically rich countries have low levels of socialism. While countries like Denmark and Sweden have generous welfare systems, they are fundamentally market economies. While prices are directly and indirectly influenced by governments, they are ultimately market prices. They are *discovered* through the multitudes of interactions between buyers and sellers.
f. ***Critically***, we should not claim that free markets always lead to the most efficient outcome. Besides complications like pollution and monopolies (ideas discussed in microeconomics), people will make mistakes.
g. But the question is not what is perfect—comparing anything to an imagined ideal is the Nirvana Fallacy—but what is most robust against error. Socialism will sometimes stubble into the right answer and capitalism will sometimes be inefficient, but capitalism is far, *far*, ***far*** more reliable to generate a wealthier world.