

CHAPTER 3

That's Not the Way We Do Things!

Why are some countries so rich and others so poor? Does the presence of abundant natural resources account for a country's wealth? Why is there such a lack of economic development among different indigenous groups around the world? How important is government to an economy, and what are the government's appropriate economic roles? If you are interested in understanding what these answers might be, then a study of the different economic systems will shed some light.

Different Economic Systems

Regardless of the time in history or the geographic location, every society has had to and will continue to deal with the fundamental problem of scarcity. In order to survive, society must make decisions about how to best use its scarce resources (land, labor, capital, and entrepreneurial ability). Economists have concluded that for societies to survive with their limited resources, they must answer three basic questions: What to produce? How to produce? Who to produce for?



The eighteenth century, also known as the Age of Reason, or the Enlightenment, saw a fundamental shift in the way people viewed their world. The year 1776 was especially important, for it not only was the year that Thomas Jefferson wrote the Declaration of Independence, but it was also the year that Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* was published.

Throughout history people have developed a variety of systems to answer these questions. Most primitive societies developed what economists refer to as traditional economies. With the development of civilization came command economies, and following the Enlightenment, market economies finally emerged. In addition, combinations of these primary systems developed such as communism, socialism, and capitalism.

Traditional Economies

What do the Inuit, the Bushmen of the Kalahari, Aboriginal Australians, Costa Rica's Bri Bri, and the Dani of New Guinea have in common? If you guessed climate, then you would be way off. Instead, this list of indigenous groups from around the world is just a sample of the people who have practiced or continue to practice **traditional economy**.

In a traditional economic system, the questions of what and how to produce and who to produce for are answered by tradition. If ever you have witnessed a documentary on a primitive culture, then you have also seen a traditional economy in action. The Kalahari's Bushmen live in one of the world's harshest environments where even the most basic resources are in meager supply. In order to survive and have enough food, the Bushmen have developed a division of labor based on gender. Women perform the food gathering and men perform the hunting. The food is then shared with the whole tribe. In this type of system, stability and continuity are favored over innovation and change. The roles of the people are defined by gender and status in the community. In this system, the old, young, weak, and disabled are cared for by the group. The group shares the few possessions they have, and private property is an alien concept. For the most part, everyone in this system understands his or her relationship to the community, and as a result, life hums along in a fairly predictable way.



As the world's indigenous people are absorbed into modern economies, they often suffer. The skill sets and practices that help them to survive in the rainforest, desert, or tundra are rendered useless in a world of freeways, factories, and fast food.

Command Economies

As hunter-gatherer societies grew and eventually exhausted their natural food supplies, some survived by becoming sedentary farmers. With the advent of farming came a need for an organized system of planting, harvesting, and storing crops. This required a greater amount of structure than existed in a traditional economy. In order to ensure the survival of the society, decisions had to be made about what crops to grow and how much of the harvest to store. Over time, decision-making became centralized and the **command economic system** developed. The key characteristic of the command economy is centralized decision-making. Either one or a group of powerful individuals makes the key economic decisions for the entire society.

Examples of command systems include most, if not all, ancient civilizations, plus the communist countries of today. The pharaohs of Egypt represent the centralized decision-making present in a command economy. The pharaoh and his various officials made the key economic decisions of what to produce, how to produce, and for whom to produce. The decisions might have gone something like this, "I command you to construct a big pyramid of brick and mortar using slaves for labor, and all of it is for me." The advantage of this type of system is the ability for decision-makers to produce rapid changes in their society. For example, Soviet dictator Josef Stalin's five-year plans quickly transformed the Soviet Union from a peasant-based agrarian society into one of the world's industrial superpowers.



During World War II, the United States practiced command economy when the government took over factories and planned production for the war effort. Every aspect of American life was in some way influenced by government involvement in the economy. Even today you can see the influence. The modern payroll withholding system was instituted during the war to provide the government with a steady stream of tax revenue.

History reveals the tragic downside of command economic systems. As mentioned above, the pharaohs used slave labor, and Stalin's five-year plans were only accomplished through the forced relocation of millions of people and at the cost of millions of lives. Rarely do the decision-makers meet the wants and needs of the common citizen.

The state, acting as a sole producer without competition, has little incentive to provide anything more than basic necessities. As a result, no variety exists in a command economy. In addition, the citizens serve for the purpose of the economy and state, as opposed to the economy and state serving the citizens. North Korea is a perfect example. Property belongs only to the state. Many workers have little personal incentive to produce, and those that do may have little regard for quality. Individuality, innovation, and variety are completely lacking in the command system.

Hollywood illustrates this lack of choice in the 1984 movie *Moscow on the Hudson*. A Soviet saxophone-playing defector, portrayed by Robin Williams, is shown shopping in a Moscow state store, where there is a lack of food, long lines, and no choices. Later, after defecting from the visiting Moscow Circus in a Manhattan Bloomingdale's, he goes to an American supermarket. The character proceeds to pass out from the overwhelming number of choices he faces when his adopted family sends him to buy coffee.

Market Economies

In total contrast to the command economic system is the **market economy**. Market economies are characterized by a complete lack of centralized decision-making. As opposed to top-down planning, market economies operate bottom-up. Individuals trying to satisfy their own self-interest answer the questions of what, how, and for whom to produce. Instead of tradition or government mandate, the "invisible hand" of the market directs resources to their best use. Private citizens, acting on their own free will as buyers or sellers, trade their resources or finished products in the market in order to increase their own well-being. Though it might appear counterintuitive, market economies achieve greater abundance, variety, and satisfaction than either traditional or command economic systems.



Does an abundance of natural resources make a country wealthy?

Not necessarily. Resource-poor Japan is five times wealthier than Russia, which is the world's largest producer of oil and diamonds. Economists refer to this type of discrepancy as the paradox of oil. Countries that often have abundant natural resources invest heavily in extracting its resources at the expense of investing in their people.

Although they cannot be classified as pure market systems, Hong Kong, the United States, Australia, and New Zealand are representative of market economies. In each you will see a greater variety of goods and services being produced than anywhere else. Also, because the focus is not on serving the state, individuals are free to choose their vocation, own private property, and determine for themselves how to best use the resources they possess. Markets reward innovation, productivity, and efficiency but discourage complacency, idleness, and waste. If markets have a downside, it is that those who are unable or unwilling to produce because of either circumstance or choice are often sidelined and unable to enjoy the benefits of the system.

Capitalism Versus Socialism

Today, traditional economies are few and far between, command economies are waning, and pure market economies are nonexistent. What does exist throughout much of the world are varying combinations of command and market systems; in effect, economic hybrids. The two most common economic hybrids are **socialism** and **capitalism**. Imagine an economic continuum with a pure command economic system on the left and a pure market system on the right. If you were to arrange modern nations along this continuum, towards the far left would be places like North Korea and Iran, in the middle would appear many western European and Latin American nations, and to the right would appear many former British colonies, such as the United States, Australia, and Hong Kong. For all practical purposes, those nations on the left were described in the discussion on command economies. However, the middle and the right of the continuum represent the dichotomy of socialism and capitalism.



Do not confuse capitalism with democracy. The two do not necessarily go together. India is the world's largest democracy, but it is considered a socialist economy. Hong Kong has never really experienced democracy and yet it is the epitome of capitalism.

The difference between these two systems lies in the degree of government influence and state ownership of the factors of production. Countries that are capitalist rely on market prices for efficient product allocation, promote the private ownership of economic resources, and leave most economic decisions to individuals. They do, however, permit for government to regulate markets, preserve competition, subsidize and tax firms, enforce private contracts, and redistribute income from workers to nonworkers. For example, the United States government creates rules for the labor market, breaks up monopolies, subsidizes corn growers, taxes polluters, hears cases involving breaches of contract, and collects social security taxes.

In socialism, the government takes a much more active role in the economy. Although individuals are allowed private property, the state may own firms in key industries and regulate even more economic decisions than in capitalism. In France it is not uncommon for the government to take a major stake in French companies, if not outright own them. The French labor market is more heavily regulated than its American counterpart. In 2006, French students poured into the streets, protesting the fact that the government was being pressured by French firms for the right to fire employees at will during their first two years of employment. Compare this to the United States where there is no guarantee of employment.



British Prime Minister Margaret Thatcher is credited with reversing the United Kingdom's drift towards socialism. With the end of World War II, the British had moved towards socialism with the nationalization of several key industries. While in office, she began the process of privatization where state-owned companies were sold to private shareholders.

More often than not, socialist countries manage the prices of many goods and services. The EU manages prices on such

things as pharmaceuticals, cell telephone service, and food. Also, socialist countries are more active in taxing in order to redistribute income from workers to nonworkers. Germany is well known for its generous cradle-to-grave social welfare system that promises care for its citizens. The German welfare state is financed by a redistributive tax system that many Americans would find intolerable. As of 2008, the highest marginal tax rate on personal income in Germany was 45% compared to the United States rate of 33%.

Adam Smith, Karl Marx, and Human Nature

According to John Maynard Keynes, "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist." Keynes's insight into the influence of economic thought on the lives of people can be seen in the various economic systems that have developed over time. In one camp are those who would have the state as the primary caretaker of the people. In the other are those who believe that the problem of scarcity can only be addressed through individual economic freedom.

Karl Marx said, "From each according to his abilities, to each according to his needs." Marx envisioned an economy where the problem of scarcity was addressed through the complete redistribution of wealth and income, from the owners of land and capital to the workers. In his utopian vision, social justice, economic equality, and relief from scarcity would be achieved when society was organized in such a way that all were equal regardless of their level of productivity.

According to Adam Smith, "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." Adam Smith had a different vision of society. In his view, productivity was the determinant of wealth, and rational self-interest was the motivating force that would provide society a means of escape from scarcity. Adam Smith believed that when society harnessed the power of self-interest, the greatest good could be accomplished.

These two men had two very different ways of addressing the fundamental problem of scarcity. Which do you think better captures human nature? If you believe that people are basically good and seek to serve one another, then the ideas of Marx ring true. However, if you believe that people are at heart selfish and pursue their own ambition, then the words of Adam Smith might appear more valid. Regardless of what you believe, both Smith and Marx have managed to influence society in ways that are still evident today.

CHAPTER 4

The Story of Money

Of all humankind's inventions, money stands out as one of the most widespread and useful. A day probably does not go by that you don't use it or think about it. It's hard to imagine a time when people did not have money, and it can be scary to imagine what your life would be without it. From barter, to shells, to coin, to paper, to digital, the story of money spans much of human history.

Barter

Before money was invented, and in times when money was either worthless or extremely scarce, **barter** was used as a means for people to get what they needed or wanted. Barter is simply the act of exchanging one good or service for another good or service. An example of barter is when a farmer trades a dozen chicken eggs with the baker for a fresh loaf of bread. Although barter was more common in the past, it still exists today. In order to evade taxes, some businesses will barter their services with other businesses. To see why this happens, consider the following example. Assume that a dentist needs her car fixed and that an auto mechanic is in desperate need of a root canal. Instead of charging each other for their services and creating taxable income, both can benefit from barter. You should know that the Internal Revenue Service considers barter every bit as taxable as cash income, but that does not seem to stop many from continuing the practice.

Barter is not without its downsides. Obviously, trade will not occur unless both parties want what the other party has to offer. This is referred to as the double coincidence of wants. In the example of the farmer and baker, if the baker has no need or desire for eggs, then the farmer is out of luck and does not get any bread. However, if the farmer is enterprising and utilizes his network of village friends, he might discover that the baker is in need of some new cast-iron trivets for cooling his bread, and it just so happens that the blacksmith needs a new lamb's wool sweater. Upon further investigation, the farmer discovers that the weaver has been craving an omelet for the past week. The farmer will then trade the eggs for the sweater, the sweater for the trivets, and the trivets for his fresh baked loaf of bread. Whew! There has got to be an easier way to do things.

The Development of Money

The previous example illustrates the need for a more efficient means of exchanging goods and services. As a result of the downsides to barter, cultures in different times and places eventually developed money. Consider cattle. Cattle were immensely useful in the past. They provided meat, milk, leather, and if harnessed, power. Throw in the fact that their dung could be used for fuel or fertilizer, and it becomes obvious that to the people of the past, cattle were as good as gold. Cattle served as one of the earliest forms of money because it seemed everyone could use them. Because cattle were universally accepted, they served as an efficient means of exchange. Now, before you consider trading in your dollars for cows, consider that your dollars do not wander off, nor must you feed them. Add to that the fact that cows do not fit in the average-sized purse, and you can see that money needed to evolve further.

Functions and Characteristics of Money

Regardless of the form it takes, **money** is anything that functions as a medium of exchange, store of value, or standard of value. **Medium of exchange** means that money is being used for the purpose of buying and selling goods or services. Money acts as a store of value when you get it today and are still able to use it later. Money is functioning as a standard of value when you are using it to measure how much a good or service is worth. When you write a check for a friend's wedding gift, then you are using money as a medium of exchange. Imagine that you go to the wedding in June and slip fifty dollars into your suit pocket for some spending cash. Now imagine that it is November of that same year and you are now at your friend's divorce hearing (things did not work out). In the midst of the hearing you reach your hand into your pocket and shout for joy, "Store of Value!" Although you feel awkward, you are pleased because the fifty dollars is still worth fifty dollars. After the scene you caused in the courtroom, you discover that court-ordered sensitivity training is going to cost you \$150 per session. That would be using money as a standard of value.

Money works best when it has the following characteristics: portability, durability, divisibility, stability, and acceptability. **Portability** refers to the ease with which money can be carried from place to place. It is desirable for money to be **durable** so that when you forget to remove it from your pocket before doing the laundry, you do not wind up broke. All of that annoying change that seems to find its way between the cushions of your couch is proof that money is **divisible** into smaller, peskier units. **Stability** exists when money's value does not vary too much. **Acceptability** helps to explain why you are far more likely to stop and pick up a ten dollar bill as opposed to ten dollars in Monopoly money.