

# What is an *economy/economic system*?

August 30, 2016

The lecture covers material that appears in the Introductory Chapter and first Chapter Krugman and Wells.

All societies need to determine what to produce, how to produce it, and how to distribute it.

That is, they need to figure out how to allocate their scarce resources and how to distribute the produced goods and services.

**Everyone has heard of a market economy. Markets are one way to allocate resources. Most resources in the U.S. are NOT allocated by markets, many but not most.**

We live in a mixed economy.

Your coming to class today is part of the allocation of society's scarce resources because your time is one of society's scarce resources. The production of one pizza at Nick'n'Willy's pizzeria on Pearl Street, and my buying it and bringing it home to bake is also part of the allocation of resources and distribution of goods.

So is the amount of time you sleep tonight (and where), the size of your parent's house, and whether you go, this evening, to a bar, a church, or both.

All of these outcomes/allocations are determined by some **process or processes**

The question is what process or processes?

A society's (or country's) *economic system* is, in brief, the **processes** it uses to determine what is produced and how it will be distributed (who gets what)

There are many processes that can be used to **determine what is produced and who gets what**:

A market process

A command and control process

A political process

Intra-group bargaining if the group is small.

After we have finished discussing these different processes, think back to why I use the term *process*.

We will start by discussing a simple allocational/distributional process, or at least one that is easy to describe.

## A command and control economic process

I will start with and *command and control* because it is the simplest to describe. One might also call it a *dictatorial process*.

Put simply the process is “C and C” if there a commander (an individual or a group) who decides what will be produced, how it will be produced, and who will get it.

If your time tonight will be allocated by your dad saying, “Go to the movie with George. Be home by eleven, and then go to bed,” and your father controls you, your time is being allocated by a C and C process.

If you time tonight is controlled by you, and you decide to sleep, your sleeping was determined by a C and C process with you as the commander and controller

There is C and C to different degrees. All of a society’s allocational and distributional decisions could be made by C and C, but this would be unusual.

More typically, C and C is used to allocate and distribute resources within certain economic institutions such as the firm, the family, the U.S. Department of Defense, and the Catholic Church. In addition, you command and control a lot of your own actions, but not all of them.

In the U.S., many allocations are determined by a C and C process. The same is true most everywhere.

A C and C system controlled by me might decide that all or most of society’s resources should be allocated to producing fine, single-sourced dark chocolate and gorgeous red wine, and 93% of the wine and chocolate should be given to me.

The commander, me, says you will work in the vineyards for one bottle of swill a week, and will be punished severely if you are caught texting.

The commander needs a mechanism to enforce her or his commands.

A commander without control can’t make things happen

If you were in control, you might choose a different basket to produce and probably decide you should get most of what is produced.

A “liberal” from Boulder, if in control, might decide that only tofu, organic vegetables, chardonnay, fixed-gear bicycles, and natural cotton clothing be produced, making sure the cotton plants and the vegetables had “great lives” that end swiftly, when they must, without expectation or pain.

And, decide that these goods should be divided equally amongst all the residents of Boulder, excluding, of course residents of Broomfield and Louisville.

In a C and C economic system with everything centrally controller, the central planner would make all economic decisions, including, for example, who you date and marry, and when you will get up in the morning. C and C is rarely/never this complete.<sup>1</sup>

C and C is typically less complete: in some economies, e.g. China, the central planner makes major decisions, but then the sub-allocations are determined by either a mini central-planner, or another economic process, such as a market. More is determined by central planning in, for example, N. Korea.

In some societies resources and goods are allocated between economic institutions by a market process, but C and C is used to allocate stuff within each institution. Such institutions include firms and families. There is a lot of C and C of this type in our U.S. economic system.

For example all of the allocational and distributional decisions made within a firm are made by C and C. Google, for example, is a big centrally-planned economy.

Even in a predominate command and control economy, at some level, the individual is allowed some control.

But that is still C and C in the sense that the individual is controlling what he or she does.

That said, under [Pol Pot](#), a now dead Cambodian dictator, much of life was controlled by the State, through camps.

A planner might be:

- A dictator: Dictators are common.

---

<sup>1</sup> In the past and still in some places, who you date and marry is controlled by someone else.

- An elected government: The U.S. Government uses C and C to allocate and distribute some resources and goods.
- Your mom or dad: The way many resource decisions are made that involve children
- Your wife, or husband or kid (most likely the wife or kid): How are resources allocated in your household?
- Dead patriarchs: honor the wishes of your dead relatives.
- God: A lot of resources in the U.S. are allocated on the basis what people believe God “wants.”
- The tribal chief: no longer common in the U.S.

How are production and allocational decisions made within your family?

How are production and allocational decisions made within the Catholic Church?

How are production and allocational decisions made within General Electric?

General Electric, Apple, and Google are three of the largest centrally-planned economies in the world.

Cuba is an example of top-down command and control economy. (C and C in Cuba has weakened, a bit, since Fidel retired.)

The Catholic Church is a very large C and C system: the Pope being the ultimate commander. (That said, he does not have as much control as Popes in the past.)

Modern China was, historically, a centrally-planned economy where the plan now allows for the market to make more and more production and distributional decisions—the proportion of the decisions determined by the market is increasing.

An example: the municipal government of Guangzhou recently decided to greatly reduce the number of cars in the city (New York Times, 09/05/2012: [“Chinese motor city limits cars”](#)). This was a C and C planning decision, an interesting one because Guangzhou is the Detroit of China.

They are achieving their goal, in part, by limiting the number of license plates (a C and C decision), but then auctioning off the plates to the highest bidders, a market process.

***Political processes and intra-group bargaining are another way that resources are allocated and goods and services are distributed.***

Imagine bargaining (in person, by text, etc.) with a group of friends about what you all are going to do this weekend, or the citizens of a small New Hampshire town meeting to decide whether to plow the roads more often.

Consider how many production and distribution decisions, like the following, are determined by the government

Increased (decreased) taxes and more (fewer) public goods?

More tanks or more military planes?

Whether poor kids will have more to eat?

How much of our resources should be allocated to public education?

Should we attack wherever (Iraq, Iran, Syria, North Korea, etc.)?

The influence of monetary and fiscal policies

## **The *market* is another type of allocational and distribution process**

Markets are more difficult to describe than some of these other processes

There is no central planner – no one is in charge.

A market system is based on property rights (all resources are owned by someone –meaning you cannot be taken from the owner without the owner’s permission. In addition, the owner has the right to pass ownership on to another party.)<sup>2</sup>

Given property rights, the only way to legally get something from someone is for them to gift you, or for you to give them something in exchange for it.

You will only give me the drugs in your trunk if I give you a bunch of money

I can only buy shares in Whole Foods if I am willing to pay the going price on the stock exchange.

---

<sup>2</sup> Property rights actually come in degrees. For example, if you own a home in the U.S., with that ownership comes the right to sell it. But, in Cuba ownership of your home means you get to live there, but it does not mean you can sell it.

Put simply, one can only sell what they own, and one will only sell it if they can get for it more than it is worth to them.

Potential buyers can only acquire an item if they offer the owner of the item more than the item is worth to the owner.

That is, a potential buyer will only be a buy if their willingness-to-pay (value) for the product is equal to or greater than the seller's willingness-to-accept the offer.

If these conditions are met, and the two individuals can find one another, a trade will take place.

## What is a trade?

It is a voluntary exchange of stuff where all parties to the exchange are made better off by the exchange, or, at least, expect to be better off.

(I should qualify the above a bit: some parties to the exchange might be no worse off, rather than strictly better off.)

When I buy a Diet Coke at the burrito place, I make myself better off because I would rather have the Diet Coke than the \$1.50 I pay for it. And the burrito place is made better off as well because they would rather have my \$1.50 than the can of Diet Coke

Let's say you and I each get a book for our birthdays, and we each prefer the other's book. We trade books: a voluntary exchange that makes both of us better off (a trade).

I sell you a kidney on EBay so I can buy a place in Italy (I prefer a world where I have an apartment in Italy and only one kidney to a world two kidneys and no apartment). You buy my kidney because you prefer a kidney and less money to a world of more money and no kidneys.

## What is a market?

A market is a place where agents (individuals, firms, organizations, the government, etc.) come together to trade, where they find each other and make voluntary exchanges.

The market can be a physical place like the New York Stock Exchange or Whole Foods, or it can be a virtual place, like EBay.

Trades can be commodities for commodities (direct **barter**) or commodities for money. In most advanced markets there is little direct barter, rather, one sells something for money and then uses the money to buy something else.

**Putting all of these together, a “pure” market economy is one where what is produced and who gets it is determined completely by voluntary and unrestricted trades between economic agents.**

We do not live in a pure and full market economy—not even close.

There are no pure market economies

In a market economy there is no centralized decision maker; outcomes are determined by the voluntary unrestricted trades amongst society’s members

Market economies are based on tradable property rights – if there are no property rights, defined for a commodity, there will be not be a market where trades for that commodity take place.

As an aside, for a market economy to work, property rights must be enforced. This requires at least some government, so some amount of government is required for a market economy.<sup>3</sup>

---

<sup>3</sup> In many developing countries property rights are defined by the government, but not adequately enforced by the government, making it difficult for markets to work to their potential. Note that even members of the Tea Party want property rights enforced.

## **What is the economic system in the U.S.?**

The U.S. economy is a *mixed economy*, not a pure-market economy

In the U.S. while many of the production and distribution decisions are made by the market, a large proportion are not.

### **Many production and distribution decisions are made by the government.**

For example, the Federal Government has allocated a lot of our resources to fighting in foreign conflicts. It decided to produce two (or three?) current wars (the market place did not make this decision) and by producing these wars we all consume the outcomes.

The right to tax us has nothing to do with the market (getting taxed is not a voluntary exchange between you and your government).

The government, once elected, allocates by political processes. Some of the players are elected (e.g. President, Congress, your city council) and some are appointed (e.g. judges). How they make decisions is determined by certain rules (a constitution, tradition, etc.)

How the political process works varies across governments. Sometimes it works well; sometimes it does not work well.

People who belong to the “Tea Party” think that no resources (or few) should be allocated by the government. While many member of the Tea Party would say they want more decisions made by the market, I am not sure they really mean this. For example, they might want more allocational decisions made by the family or the church.

## **Many of the decisions about what will be produced and consumed are made within households by C and C, not by the market**

My daughter does not trade me money for dinner (a market transaction). Rather, I tell her what she is having, she says no, and then I make her pot stickers.

I do not pay my wife money on Saturday morning to entertain the kid so I can go on a bike ride. Rather, she, dictatorially, says, “I am going running an hour after I wake up, whatever time that might be.” And I oblige.

You probably do not pay your significant other to have sex with you, at least not directly.

Child care today is often determined by both market transactions and central planning, or bargaining, within the family.

,

Historically, most child care was done by a stay-at-home parent, or other relative (who that was was determined by tradition and central planning within the household—tradition says female).

Now there are many market options: day care, camp, baby sitters. Now, most households in developed countries choose some mixture of market and non-market production of childcare.

In many developed economies some amount of day-care is provided by the government. Some is provided in the U.S. (e.g. Head Start) but much more, for example, in some European countries, for example, France and Sweden.

## Decisions inside a firm are not made by the market

When I was in college, part of one summer I worked on an assembly line that made diesel engines.

Is the following a description of how an assembly line works?

The person to my left, who has just attached the carburetor to the engine, turns to me and says, “Want to buy an engine?” We agree on a price and I buy the partially assembled engine, for money. I then turn to a guy standing behind me who happens to be selling air coolers, and we negotiate on a price until I buy an air cooler. I then attach the air cooler to the engine. Only then do I turn to the guy to my right on the assembly line and say, “Want to buy this engine with a brand new air cooler?”

This is how the market would make engines, but this is not how engines are built inside the factory.

I attached the air coolers as fast as I could because that is what the foreman told me to do.

I did not last long.

My fictional narrative above is a description of how production sometimes takes place, but not a description of how it takes place within a firm.

Imagine that a restaurant did not exist as a firm managed by C and C, but rather meal production is determined within the “restaurant” completely by market transactions.

The waitress walks into the kitchen and says, “I want to buy a steak and lobster dinner with a side of garlic bread.” After that deal is made, the cook turns to the guy who is selling lobsters and says, “Hey buddy, Ya wanna sell a lobster?” When the meal is prepared, the waitress sells it to the customer. There is no restaurant manager or owner.

This is not how a restaurant firm operates.

The taking of a job is a voluntary exchange between an individual and a firm; it is a market trade. But once inside the firm, what you do on company time is dictated by your boss, not by the market.

When a firm buys inputs, it is entering into a market transaction, but how it uses those inputs is not determined by the market.

When a firm sells its outputs, it is entering into a market transaction.

But how they produce their product is not determined by market transactions.