Two Visions Shape Two Economic Systems

This section examines the two major economic systems—capitalism and socialism. Each is based on a certain vision of the way the world works.

Economic Systems

An economic system refers to the way in which a society decides to answer the three economic questions: What will be produced? How will the goods be produced? For whom will the goods be produced?

There are hundreds of countries in the world but only two major economic systems: the capitalist (or market) economic system and the socialist economic system. One might think that every country’s economy would fall neatly into one of the two economic system categories, but things are not so simple. Some countries’ economies do fall naturally into one category or the other, but many countries have chosen “ingredients” from both economic systems. These countries have economies that are neither purely capitalist nor purely socialist; instead, they are some mixture of both and are therefore called mixed economies. For example, the economic system that, to different degrees, exists in the United States, Canada, Australia, and Japan, among other countries is generally known as mixed capitalism.

It is best to think of capitalism and socialism as occupying opposite ends of an economic spectrum. Countries’ economies lie along the spectrum: some are closer to the capitalist end, and some are closer to the socialist end.

Different Visions Shape the Different Economic Systems

The two major and radically different economic systems—capitalism and socialism—reflect two major and radically different visions, or views, of the world. To understand socialism and capitalism, you must first understand the visions of the world that have given birth to them. Socialism did not fall from the sky, full-blown and complete, for people to pick up off the ground and put into operation. Nor did free enterprise, or capitalism, suddenly come out of nowhere. Both systems are the product of a certain way of looking at, understanding, and explaining the world. Both developed from certain visions.

The economist Thomas Sowell defines vision as “our sense of how the world works.” For example, Smith’s vision of the world, as it relates to government, may be that our elected officials are endlessly trying to solve society’s problems in a way that is good for the general public. Brown’s vision may be quite different: he may believe that our elected officials respond to narrowly focused special-interest groups at the expense of the general public. These different visions of how government works will shape the policies that Smith and Brown will propose. For example, Smith would be much more willing than Brown to argue that government should play a major role in solving society’s problems. He takes this position because, in a real sense, he envisions government doing the right thing much more often than Brown does.

What Shall We Call the Two Different Visions?

For simplicity’s sake, we shall call the vision that produces socialism the socialist vision and the vision that produces capitalism the capitalist vision. It is important not to fall into the trap of thinking one vision is better or worse than the other because
of what it is called. For example, you may be inclined to think that socialism is “bad” and capitalism is “good,” or vice versa, and therefore to believe that the vision that gives rise to your preferred economic system is a better vision than the other. You should resist the temptation to prejudge. It is not our purpose to label either of the two visions or either of the two major economic systems as “good” or “bad.” Our purpose is to understand the intricacies of each vision and then to understand how those visions could give birth to different economic systems. At this stage, we place our emphasis on understanding instead of judging.

**The Two Visions as They Relate to the Market**

The proponents of the two visions—we shall call them socialist thinkers and capitalist thinkers—have different views of the free market. In this section we discuss their views on several market phenomena.

**Prices.** When we buy something in a market—whether it is a car, a house, or a loaf of bread—we pay a price. Prices are a common market phenomenon. The capitalist thinker sees “price” as doing a job: price (1) rations goods and services, (2) conveys information, and (3) serves as an incentive to respond to information.

The rationing role of price is discussed in Chapter 3. Recall that price rationing goods and services in that those people who are willing and able to pay the price of a good obtain the good; those persons who are not willing and able to pay do not obtain the good. Living in a world of scarcity, where people’s wants outstrip the resources available to satisfy those wants, necessitates the use of some rationing device—whether it is price, first-come-first-served, brute force, or something else. For capitalist thinkers, there needs to be some way of determining who gets what of the available resources, goods, and services. Price serves this purpose.

Now consider an example to see how price can convey information and serve as an incentive to respond to information. Suppose Tom buys a dozen oranges each week for 40 cents an orange. One day, a devastating freeze hits the Florida orange groves and destroys half the orange crop. As a result, the supply of oranges falls and the price per orange rises to 60 cents. Tom notices the higher price of oranges and wonders what caused the price to rise. He has not read the news about the freeze, and even if he had, he might not have connected the freeze with a reduced supply of oranges and higher orange prices. Nevertheless, Tom responds to the higher price of oranges by reducing his weekly purchase from 12 oranges to 8 oranges.

Let’s consider the role price has played in this example. First, through an increase in price, the “information” of the freeze was conveyed to buyers. Specifically, price has transmitted information on the relative scarcity of a good. The higher price for oranges is saying: “There has been a cold spell in Florida resulting in fewer oranges. The gap between people’s wants for oranges and the amount of oranges available to satisfy those wants has widened.”

Second, by rising, price has provided Tom with an incentive to reduce the quantity of oranges he consumes. Tom responds to the information of the increased relative scarcity of oranges, even without knowing about Florida weather conditions.

At this point a capitalist thinker would emphasize the “social function” that price has served in this example; specifically, it has caused Tom to reduce his purchases of a good that has become increasingly scarce. She might say, “A freeze has changed the world: there are fewer oranges in it. Given this fact, it is desirable that people respond to this new reality by conserving (cutting back) on their purchases of this increasingly scarce good.” And this is what people do when they buy fewer oranges.
as a result of the higher price of oranges. There is no need for directives instructing people to cut back on their orange consumption in the face of increased relative scarcity; people respond naturally to changes in price.

A socialist thinker views price in a very different light. The rationing, information-transmitting, and incentive-producing functions of price are largely invisible to or ignored by the socialist thinker. Whereas the capitalist thinker views price as being determined by the impersonal forces of supply and demand, a socialist thinker views price as being set by greedy businesses with vast economic power. Perhaps because of this, the socialist thinker is ready to "control" price. He is willing to have a law passed stating that it is illegal to charge more than a certain price for, say, gasoline or rental homes, or that it is illegal to pay less than a certain wage to workers. By passing laws that make it illegal to charge more than a certain price for certain goods and services, the socialist thinker seeks to reduce some of the economic power that he believes sellers have over consumers. By passing laws that make it illegal to pay less than a certain wage to workers, the socialist seeks to reduce some of the economic power that he believes the owners of businesses have over workers.

**Competition.** A capitalist thinker views a free market as always exhibiting intense competition. For example, the competition among producers will force them to offer the highest-quality product to consumers for the lowest price. A socialist thinker views a free market as largely being controlled by big business interests that dictate to people (sometimes through manipulative advertising) what they will buy and at what price.

**Private Property.** The capitalist thinker places high value on private property. She agrees with the Greek philosopher, Aristotle, that "What is common to many is taken least care of, for all men have greater regard for what is their own than for what they possess in common with others." In other words, if you own something—if your car or house is your private property—you are more likely to take care of it than if it was owned by you and others (communal property) or if it was owned by the government (government property).

The capitalist thinker also believes that private property encourages individuals to use their resources in a way that benefits others. For example, suppose Johnson owns a factory that is his private property. If Johnson wants to maximize his income, he will have to use his factory to produce goods that people are willing and able to buy. If he produced something that people were not willing and able to buy, he would not benefit people or earn an income. In a free market, where private property exists, the only way to make yourself better off is to use your property in a way that benefits others.

The socialist vision of property is very different. The socialist thinker believes that those who own property will have more political power than those who do not own it and that they will use their greater political power to their advantage and to the disadvantage of others. To the socialist thinker, it would be better for most of the property in the economy (such as factories, raw materials, and machinery) to be owned by the government because government would be more likely (than private individuals) to make sure this property was used to benefit the many instead of the few.

**Exchange.** Consider an ordinary, everyday exchange of $100 for some clothes. The capitalist thinker believes that both the buyer and seller of the clothes benefit from the exchange or else they would have not entered into it. The socialist thinker
often (but not always) sees one person in an exchange as being made better off at the expense of the other person. In this example, perhaps the clothes seller took advantage of the buyer by charging too much money for the clothes.

Q: Is one vision of how the world works correct and the other incorrect?

A: Our purpose in this section is not to determine if one vision is correct and the other incorrect. Our purpose is to understand the capitalist and socialist visions of the world so that we can see how each vision—right or wrong—has led to a specific economic system. Consider an analogy. Suppose your vision of the world is that it is frightening and dangerous because everyone is trying to hurt everyone else. As a consequence, you rarely leave your home. Your vision of the world—right or wrong—has caused you to take a certain action: you stay home. If we want to understand why you choose to stay home, it is important that we know your vision. Similarly, if we want to know something about the socialist economic system, we need to know about the vision of the world that is implicit in that system.

The Two Visions as They Relate to Government

Capitalist and socialist thinkers have different visions of government. The socialist thinker sees government decision makers as promoting the best interests of society as a whole. For example, given a choice among four alternatives, A–D, with only option C being the best for all of society, government decision makers will choose C. The capitalist thinker thinks this is a naïve view of government. He views government decision makers as responding to well-organized special-interest groups and not to the unorganized members of the general public. For example, he believes government is more likely to respond to the farmers who lobby for higher prices for agricultural products than to the consumers who will pay higher food prices in the grocery stores.

The socialist thinker believes the goal of government decision makers is to do the right thing; the capitalist thinker believes the goal of government decision makers is to get elected and reelected to office. The socialist thinker believes that when government decision makers make a mistake, it is because they did not have all the facts. Give them the facts, and they will do the right thing. The capitalist thinker believes that when government decision makers make a mistake, it is just as likely to have been politically motivated as due to a lack of information. Give them the facts, and they may still do what is in the best interest of the well-organized special-interest groups at the expense of the general public.

Thinking Like an Economist

The layperson often thinks that business firms advance the capitalist vision, but this is not necessarily correct. There are numerous examples of business firms lobbying government for legislation that would actually hamper the free enterprise system. For example, some business firms in the United States lobby for tariffs and quotas on foreign products that compete with the products they produce and sell. But, U.S. tariffs and quotas help American producers (by reducing the competition they face from foreign producers) and hurt American consumers (by raising the prices consumers pay); they are not indicative of the capitalist vision. It is perhaps natural to connect business firms with capitalism and thus to believe that all business firms naturally have and advance the capitalist vision, but in reality this is not true. In real
ity, narrow business interests are not always best served by a system like capitalism that emphasizes competition, prices determined by supply and demand, and free and voluntary exchange (trade). Being pro-business and being pro-free enterprise are not always the same. The benefits of free enterprise often fall most profoundly to consumers, not producers.

The Two Visions as They Relate to Unintended Consequences and Deliberate Actions

According to the capitalist thinker, individuals’ actions sometimes have unintended consequences. For example, consider the equilibrium price in a market. It corresponds to the intersection of the supply and demand curves. As discussed in Chapter 8, at equilibrium price the quantity of the good that buyers are willing and able to buy equals the quantity of the good that sellers are willing and able to sell. In other words, both buyers and sellers are content at equilibrium price: buyers don’t want to buy more or less, and sellers don’t want to sell more or less. The important point is that this “balance” between buyers and sellers came about naturally. Buyers and sellers did not follow a blueprint to get to equilibrium price; no government committee identified equilibrium price and then directed buyers and sellers to trade at it. Equilibrium price simply emerged as an unintended consequence of buyers and sellers buying and selling goods. To a capitalist thinker, what emerges naturally—like equilibrium price in a free market—is often desirable; specifically, it is desirable that both buyers and sellers are content at equilibrium price where buyers don’t want to buy more or less and sellers don’t want to sell more or less.

In contrast, the socialist thinker rarely thinks in terms of desirable properties that emerge naturally as the unintended consequences of individuals’ actions. The socialist thinker concentrates on things that were deliberately created to serve some purpose. For example, the socialist thinker may focus on government programs that were deliberately created and designed to reduce poverty. For him, here is something tangible: a problem exists (poverty) and a program was created and designed to deal with it.

To summarize, the capitalist thinker focuses on things that were not deliberately created but emerged naturally as the unintended consequences of individuals’ actions. The socialist thinker focuses on things that were deliberately created to serve a purpose.

This difference in focus, or vision, has consequences. The capitalist thinker does not want to disturb the natural (and often invisible) processes at work in society that bring about desirable outcomes. For example, she would argue that government should not interfere with the free-market forces of supply and demand because any interference would reduce the likelihood of equilibrium price emerging. To the socialist thinker, this argument sounds like so much fantasy because he does not believe in equilibrium’s existence nor in any of its desirable properties. To him, there is no good reason for government to take a “hands off” approach to supply and demand forces.

It is still difficult to understand that desirable things may exist even though no one directly set out to create them. Are there other examples besides equilibrium price?

Consider money. At one time, people had a barter economy where there was no money; people traded goods for other goods, such as an apple for a banana. Making trades is time-consuming in a barter economy. For
example, suppose you have apples and you want bread. You locate someone with bread, but she says that she doesn’t want to trade her bread for your apples; she prefers oranges. You set out to find someone else who has bread, and hope that this person is willing to trade bread for your apples; or you try to find someone with oranges who wants to trade oranges for your apples, after which you will go to the person with bread and trade oranges for bread.

Individuals in a barter economy had one objective: to make trades less time-consuming and thus easier. They noticed that some goods were more widely accepted in trade than others. For example, if there are seven goods, A–G, in a barter economy, G may be more widely accepted for trade than the others. A person in a barter economy would therefore know that if she had good G, she would be able to make her trades in less time than if she had, say, good A, which was not as widely accepted as good G.

As more people began to accept good G for what they traded, G became even more widely accepted for trade, and still more people were willing to accept G in exchange for what they had to trade. At some point, good G became widely accepted in trade and became known as money.

In conclusion, money, which is defined as any good that is widely accepted in trade, emerged as an unintended consequence of people in a barter economy simply trying to make their everyday trades less time-consuming and easier. No one person said, “Here is a good idea: let’s invent money.” No king or queen had the idea of money. Money simply emerged, naturally, without any blueprint of action and without any government committee recommending it. No one intended for money to come into existence; instead, the people living in a barter economy simply wanted to make life easier. They wanted to make their trades in less time and with less effort. And as a consequence of their trying to do this, money came to exist.

The Two Visions in a Nutshell

We have discussed the details of the capitalist and socialist visions as they relate to (1) the free market, (2) government, and (3) unintended consequences and deliberate actions. Let’s bring the material together and summarize.

The capitalist vision holds that the free market—which emphasizes free prices, competition, private property, and exchange—is a marvelous “system” for rationing goods, conveying information, producing high-quality goods at the lowest prices, getting people to use their resources in a way that will benefit others, and generally raising people’s standard of living. The socialist vision holds that the free market leads to some people exploiting others—for example, by charging high prices, paying low wages, and manipulating people’s preferences (through such things as advertising). Socialist thinkers see the free market as a “system” that enables some people to make themselves better off at the expense of other people.

The socialist vision holds that government is made up of people who want to and will in most cases do the right thing by the general public. The capitalist vision sees government as made up of people who will respond more readily to well-organized special-interest groups than to the general public. Socialist thinkers are more inclined to trust the intentions and actions of government decision makers than capitalist thinkers are.

The capitalist vision focuses on the desirable qualities of those things that were not deliberately created but emerged naturally as the unintended consequences of people’s actions. The socialist vision focuses on those things that were deliberately created to serve a purpose.