CM13: MARKETS AND COMMANDS (4-21-20)

MOST, BUT *NOT* ALL, OF WHAT YOU NEED TO KNOW

I WOULD LIKE YOU TO READ SECTION 1 CAREFULLY. I BELIEVE THAT ANYONE STUDYING ECONOMICS (OR READING POPULAR BOOKS ABOUT ECONOMICS) SHOULD BE AWARE OF THE POSSIBILITY THAT WHAT THEY ARE LEARNING MAY BE DEEPLY, ALTHOUGH IMPLICITLY, IDEOLOGICAL. NATURALLY MOST ECONOMISTS WOULD VEHEMENTLY DENY PROPOUNDING AN IDEOLOGY. SECTION 4 PROVIDES BACKGROUND MATERIAL, READ BUT DON'T STUDY IT. I WILL NOT EXAMINE YOU ON THIS MATERIAL. **CONCENTRATE ON SECTIONS 2 AND 5 AND 6.**

1. What is a market?

2. Are markets in 2020 like those in Adam Smith's England in 1776?

3. What do economists mean when they use the term "market"?

4. What markets in 2020 would be reasonable approximations to the economists' concept of a market?

5. What is meant by the term "market fundamentalism"?

6. Is "market fundamentalism" consistent with economists' concept of a market economy?

7. Does the US economy correspond with the economists' idea of a "market economy"?

8. Is the government the solution to all economic problems?

9. What are the three problems that all economic systems are forced by scarcity to solve?

10. What are the two major ways for economies to solve these problems?

11. Are all economies alike?

12. In 2020 which economies are most like command economies and which are most like market economies?

13. What is a Kleptocracy?

14. What sort of economy is the US economy?

15. How do market and command economies differ with respect to private ownership?

16. Why is resource allocation of consumer goods and services so difficult in command economies?

17. Why are the different incentive structures that characterize command and market economies so important?

18. Why have most LDCs and ex-Soviet Block economies moved away from central planning and towards markets?

Markets are not, in my opinion, a full solution to any problem. The obvious problem they don't meet is the concerns of the welfare of individuals who may get lost in the operation of the system - the distributional question. We've seen this growing as we go further and further toward a market ideology in the United States and the United Kingdom. We've seen a decline in the welfare of the working poor, leaving aside any other pathologies, just the working poor, a very distinct increase at the very top levels. Kenneth Arrow Nobel laureate and probably the best economic theorist of his generation, with the possible exception of his brother-in-law Paul Samuelson.

1. ECONOMICS AS IDEOLOGY

1. What I am about to write is heresy among economists. They simply ignore the argument rather than going to the trouble of burning me at the stake.

2. An ideology is a set of beliefs such as Marxism, socialism, fascism, libertarianism, liberalism, environmentalism, and is analogous to the beliefs of most religious groups. The persons who hold these beliefs do not question them since they "know" that they are true. Science, which is a belief system like religion, but one that welcomes change, is willing to admit to error, seeks to eliminate inconsistent arguments, and insists on empirical verification of its beliefs. On the other hand ideologies resist change, ignore or "explains away" inconsistencies[1], and treat dissent as anathema.

3. In earlier Commentaries I have argued that economics has been largely successful in purging itself of value judgments, but although economists seldom make explicit value judgments, I believe there is a strong implicit ideological bias to much of economics. I

[1] Much theology seeks to explain such apparent anomalies as a belief in a loving, all-knowing, and all-powerful God who allows bad things to happen to good people – the problem of evil.

believe that economists share an implicit set of beliefs that, because they are implicit, go largely unquestioned. The beliefs amount to an ideology, an ideology that tends to favor market solutions against government intervention in markets. I do not believe that most academic economists have explicit ideological agendas, although some clearly do, or that academic economists in general deliberately set out to indoctrinate their students with a particular set of pro-market ideas. Much of standard economics implicitly, and sometimes explicitly, makes six assumptions about how individuals behave:

i. *Economic actors know their own tastes*; they know what is best for themselves.

ii. Those *tastes are given and stable*. This means that economists are very skeptical of the ability of firms to change our preferences by advertising and marketing, and that we are largely immune to fads and fashion.

iii. *Economic agents maximize subject to constraints*. This means two things.

(a) Consumers are assumed to maximize their satisfaction subject to a budget constraint – because they have limited incomes and wealth and because prices are positive consumers can only purchase a limited number of goods and services; they are therefore forced to make choices and economists say that they must trade-off some goods in order to acquire other goods. Economists characterize this maximization as being self-interested (non-economists prefer the term greedy), because economists usually assume that the consumers are only interested in their own wellbeing when making their decisions. Economists argue that although altruistic behavior clearly exists[2] it is also subject to constraints and therefore subject to careful self-interested calculation. But maximization can be thought of as "getting the last cents worth of benefit out of every dollar spent" and it is easy to end up thinking that this behavior is not only normal but also commendable, after all, "the invisible hand" doctrine that many economists espouse claims that when you consider only your own interests you are promoting the general good.[3]

(b) Firms are assumed to attempt to maximize profits subject to the limitations imposed by a given stock of technological knowledge, which defines the ways in which they can

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[2] Otherwise you would not be here, although we sometimes wish to strangle other people's ill-behaved children, and, occasionally, our own.

[3] The invisible hand doctrine goes back to Adam Smith but a careful reading of "*The Theory of Moral Sentiments*" and "*The Wealth of Nations*" shows that Smith was far from sanguine when considering the likelihood that in the real world that self-interested behavior would *necessarily* lead to the general good. In "*The Wealth of Nations*" Smith wrote: "By pursuing his own interest he *frequently* promotes that of the society more effectually than when he really intends to promote it." (Emphasis added.) Frequently does not mean always. Smith believed that we have empathy for our fellow humans and that empathy and the positive effects of competition would lead markets to generate beneficial outcomes.

convert labor and capital and raw materials into goods and services, and subject to the fact that these scarce resources have positive prices, which the firms must take into account when determining which inputs to use. Ariel Rubinstein, a distinguished Israeli economist, has argued that emphasis on profit maximization in economics courses taught to MBA students makes those students excessively concerned with short-term profit compared with other considerations.[4]

iv. *Economic agents are well informed* about the quality and availability and prices of all goods and services.

v. *Economic agents are in equilibrium*, which to an economist means that they actually maximize and therefore purchase those goods and services and undertake those activities, which maximize their satisfactions or their profits.

vi. Any *deviation from equilibrium* will *disappear rapidly* as rational economic agents quickly adjust to the incentives that exist when they are not in equilibrium. Economists joke that there cannot really be a $100 bill lying on the sidewalk because if it were then someone would already have picked it up, but this assumes rapid adjustment to disequilibrium.[5]

4. If these assumptions hold then it appears that we live in the best of all *attainable* worlds, a Panglossian economy. We know what we want, we know what we can get, and we choose the things that make us happiest. If we are rational in the economist's sense of the term – we are consistent and we maximize – then we have arrived at the outcome that we believe is the best possible for us. The only function for a government in such a world would seem to be to ensure that markets are competitive and then deal with market failures: correct external effects and provide public goods and services and deal with information asymmetries (CM14-16).[6]

5. Because economists are reluctant to make explicit value judgments they cannot make "interpersonal comparisons of utility" (an interpersonal comparison of utility means a

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[4] Notice that I have not mentioned the possibility that firms might make mistakes.

[5] If you have purchased used books and videos on Amazon you will have noticed that the same good is not always offered at the same price, which would be the case if everyone was well informed and sellers adjusted their prices to what other sellers were offering.

[6] "I think that modern neoclassical economics is in fine shape as long as it is understood as the ideological and substantive legitimating doctrine of the political theory of possessive individualism. As long as we have relatively-self-interested liberal individuals who have relatively-strong beliefs that things are theirs, the competitive market in equilibrium is an absolutely wonderful mechanism for achieving truly extraordinary degree of societal coordination and productivity. We need to understand that. We need to value that. And that is what neoclassical economics does, and does well." Brad De Long's Blog: 1/18/14.

comparison of one person's wellbeing compared to that of another person).[7] Economists are therefore reluctant to discuss the desirability of redistributing income and wealth. Of course, a refusal to discuss an issue can be interpreted as providing tacit support for the *status quo ante*; the existing distribution of income and wealth may become something that is not challenged.

6. Most economists are closet utilitarians. Very roughly speaking utilitarians believe that policies should be evaluated in terms of their consequences, and that a policy is "better" if it brings more people more happiness than some other policy: the greatest good to the greatest number. Utilitarianism is a hotly debated issue amongst moral philosophers but economists do not want to get tied down in those sorts of arguments and so while we preach that economics should be "value free" – we should not make ethical judgments – in practice there is an implicit ethical stance, Utilitarianism, underlying much of economics.

7. All six of the assumptions listed above are formulated as positive statements. But we have empirical evidence that most of them are at least questionable; and in some cases, they may simply be false. Assumption 1 ignores the fact that firms use marketing techniques to attempt to mold our tastes, and that (as we shall see in CM20) such techniques bias us towards individual, rather than, collective consumption goods. (It is even debatable whether firms know what their profit maximizing decisions should be.)

Economists often argue that they adopt assumption 2 because they do not want to explain away inconvenient observed behavior by simply saying that tastes have changed.

Assumption 3 is also questionable, people make mistakes and sometimes they cannot be bothered to do the calculations that are necessary to truly maximize.[8] For example: Would you be willing to take the time and go to some inconvenience to save $20 on a $100 dollar item? Would you be willing to make the same effort to save $20 on a $1,500 big-ticket item? Economists will say that you are irrational, inconsistent, if you answer yes to the first question but no to the second – a dollar is a dollar is a dollar.

Assumption 4 is seldom true. Economists concede this and we will discuss the economics of asymmetric information in CM16. However, economists seldom phrase this problem of withholding information in terms of cheating, fraud and misrepresentation. There are

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[7] The prohibition against making interpersonal comparisons of utility also explains why economists take smokers' and drug addicts' benefits into account when discussing the regulation of cigarettes and drugs, and the benefits and costs of muggers when evaluating crime.

[8] The Nobel laureate, Herbert Simon, argued that most economic agents are "satisfiers" rather than maximizers because there are limits to our cognitive abilities and to the amount of time available to make decisions.

many situations in which we are not fully informed about the quality of the goods and services that we purchase – people sometimes die because they purchase and consume products that are toxic. Sometimes sellers deliberately misrepresent or conceal the properties of the goods and services they sell in order to defraud their customers.

It is not obvious how we determine empirically whether assumption 5 is correct.

There is considerable evidence that assumption 6 is violated in labor markets.

8. I would argue that economics becomes ideological when it is uncritically assumed that all six assumptions *must* be correct. Their combined effect is to suggest that whatever we observe people doing must be in their best interest: that the unemployed are taking a vacation, rather than not working because they have lost a job and cannot find another one. (At the beginning of the Great Recession there were a large number of firings, not voluntary quits, and the ratio of job vacancies to the unemployed fell rapidly.)

9. The most important issue when considering this ideology is whether real economies can be thought of as sets of perfectly competitive markets/industries.

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2. MARKETS

"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, The Wealth of Nations, 1776, Vol. I

1. The standard definition of a market is that *a market is any organizational arrangement that brings buyers and sellers together so they may trade* or exchange, that is, buy and sell goods and services. Steven Pinker has a nice way of explaining the term market. I *give* you a cookie, I *exchange* my cookie for your banana, I *sell* you my cookie for a quarter and you buy my cookie for a quarter, *a lot of people selling and buying* cookies make up the market for cookies. Markets come in all shapes and sizes from the Bellingham Farmers' Market, where the total transactions in a day may run into a few thousand dollars, to foreign exchange markets where trillions of dollars are bought and sold in a day. There are now virtual markets like eBay.

2. Markets have been around for thousands of years: the great medieval fairs, the camel markets in the middle east, Souks, the Amsterdam diamond market, the Aalsmeer flower market in Holland where 20 million flowers are sold in a day.[9]

There are markets for dead young women and men ("Ghost brides"), a market for elephant "doodoo" (and a supply of the latter at about 300 pounds per day), there is a market for blond hair, there are markets for labor and for used cars.

http://en.wikipedia.org/wiki/Ghost_marriage_(Chinese)

http://www.theguardian.com/world/2013/mar/04/china-imprisons-men-ghostmarriage-corpse-bride

http://blog.seattlepi.com/thebigblog/2010/11/30/holidoo-zoo-sells-elephantpoop-in-time-for-christmas/

In the early nineteenth century there was a shortage of legitimate cadavers for anatomists to dissect and Burke and Hare became part of English folklore for providing fresh (murdered) cadavers for a fair price.

http://en.wikipedia.org/wiki/Burke_and_Hare_murders

3. There is an important difference between the sort of market with which Adam Smith would have been familiar and the sort of markets in which we trade today. In the past markets were to some an extent self-regulating through social pressure. The customer knew the butcher and baker, and the butcher and the baker knew that selling poor quality goods was bad for business in the long run. Similarly, people had a personal relationship with doctors and lawyers who provided them with services, and knew the owners of the shops (retailers) where they made their purchases of clothes and other items. Traders who had a reputation for "sharp" practices – selling you a horse that was blind in one eye, putting their thumbs on the scales – would have more difficulty in making trades. This meant that buyers were often better informed then we are today – their relationships with suppliers were not at a distance in the way that ours are with General Motors. Of

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[9] John McMillan has written a superb book on markets that should be on the summer reading list of potential economics majors.

http://www.amazon.com/Reinventing-Bazaar-Natural-History-Markets/dp/0393323714

http://www.zoo.org/page.aspx?pid=2001 - .UudLav2tv0k

http://www.nytimes.com/2010/11/22/business/global/22blond.html?pagewanted=all course, in recent years the Internet has made finding out about the quality of goods and services – hotel accommodation in Croatia – much easier. But the problem of asymmetric information is a very serious one, and we will see that asymmetric information causes many of the "efficient" properties of markets to fail when we return to this subject in CM18. Standard textbooks tend to downplay these information problems and to argue that one of the strengths of markets is their ability to convey information through price signals.

4. However, we seldom make transactions in "markets" as such; in our type of economy retailers[10] mediate transactions; retailers provide convenient competing "markets". I buy coffee at the grocery store not from the Nestlé multi-national food conglomerate, and certainly not from the farmers who produced the coffee in Brazil; I buy the plates and cutlery with which I eat my food from department stores not from their manufacturers in China; I buy my clothes from clothes stores not from clothing manufactures in Mexico or from textile manufactures in Pakistan; I buy my TV sets from "box" stores not from the assembly plants in Taiwan; I buy my car from a car dealer not from the Honda factory in the mid- West that assembled it; I buy my books from local booksellers or Amazon, not from the publishers or writers. Usually when I purchase something from the supplier it is a service that I am buying – a haircut, a visit to the dentist, a physical therapy session, a Pilates lesson. Entertainment services are often provided by an intermediary – I go to the cinema to see a film but do not buy from the producer or even the distributor, I go to a concert but the performers don't pass the hat around before the performance.[11]

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[10] In retail markets the seller sets the price and the buyer accepts or declines to buy. Retailers adjust to excess demand and supply by changing their inventories. Occasionally they will adjust prices but usually in the form of "sales" since buyers are happy to buy at lower prices but may resent it when prices are raised back to their original level. Price changes involve what economists call "menu costs". Think what happens to the average prices of used books in a large store like Henderson's used bookstore, whose inventory is about 250,000 books that are priced by hand.

[11] I buy gas at "gas stations" not from oil refiners or crude oil from oil companies. Gas is something whose price changes frequently as demand and supply for crude oil, and refining facilities, and oil tanker rates fluctuate over time. Oil prices are usually denominated in US dollars (until February 2016 when the Saudis announced that they would sell in Euros) and so the appreciation of the dollar in recent months will drive up gas prices. Have you noticed that Congress gets active when gas prices rise above about $3.50 per gallon but not when gas prices fall, even though oil companies are able to get larger "margins" when gas prices are low, in 2016 as low as $1.70 per gallon? Gas prices are determined by the supply and demand for crude oil in the world oil market not by pricing decisions by oil companies. (Although oil volume is measured in barrels oil is transported in oil tankers, pipelines, and trucks and trains.)

5. Economists often use the word market metaphorically, even promiscuously: they talk about markets for marriage, children, abortions, and contract killings (Murder Incorporated) where the word "market" simply signifies that economists believe that they can analyze the situation using the supply and demand apparatus that we studied in CM4.

6. Technically when economists use the term market they are talking about *perfectly competitive markets.* In a perfectly competitive market *the commodity is homogeneous* (each unit of the commodity is indistinguishable from every other unit), there are a *very large number of producers* (sellers), none of whom is big enough to influence the price of the commodity by changing their output, and there are *a large number of consumers* (buyers) who also cannot influence the price by changing the quantity they wish to buy. In perfectly competitive markets *the market determines the price*, by which economists mean that it is the interactions of these myriad transactors that set the price, not "the" seller. Price is determined by market supply and demand, as we saw in CM4.

The closest real-world equivalents to the economists' theoretical markets are the world markets for foreign exchange, stock markets, the world markets for steel and concrete, the world markets for agricultural products like wheat and beef, world markets for raw materials like copper and platinum, and world energy markets in which crude oil and natural gas are bought and sold.

Most of the markets in which we trade are best described as imperfectly competitive (monopolistically competitive) in which firms spend money on marketing and advertising to differentiate their products from those of other firms. But many of the goods that you buy in grocery stores or pharmacies are sold along side generic versions of the product. Rite Aid and Haggen do not produce these goods; they buy them from the sellers of the items on the same shelf. (See CM 22C if you are interested in learning about imperfect competition.) Monopolistically competitive markets are likely to be highly competitive, but because they claim to sell "different" products they are not as price sensitive as perfectly competitive markets. Are markets for gasoline and cappuccinos highly competitive? Do you shop around for the lowest priced gas or go to "your" gas station? Do you think buy your cappuccinos from Starbucks and switch to Woods if you notice that Starbucks is charging 15c more?

3. MARKET FUNDAMENTALISM

1. "Market Fundamentalism", a pejorative term invented by the ex-hedge fund manager and billionaire George Soros, is the widely held belief amongst politicians, television and radio pundits, economic bloggers, and even the more sober print media that *all* market

outcomes are good (socially optimal) and that *all* government intervention in markets are either unnecessary or bad (counterproductive) or both.

2. Note that this type of "black or white" formulation of a political or economic idea is very common and is something that you should guard against. An alternative approach would be to say that we must decide between a range of options: (1) markets always lead to the best economic outcomes and government intervention in markets always leads to the bad economic outcomes (100%); (2) markets usually work well but government intervention can sometimes lead to better outcomes (75%); (3) on average markets do a good job but government intervention is on average necessary to correct bad market outcomes (50%); (4) markets seldom work well and government intervention usually leads to superior out comes (25%); (5) markets never work well and government intervention is always necessary to correct market failures (0%). Market fundamentalism presents the issue as if the only possibility is (5) versus (1), ignoring the more nuanced options (2)-(4).

3. Market Fundamentalism, "the market works", is an idea that gained currency during the 1980s during the Prime Ministership of Margaret Thatcher in the UK and the Presidency of Ronald Reagan in the US; it is more prevalent amongst Republicans than Democrats, is more likely to be found in the Wall Street Journal than the New York Times, and on Fox News rather than MSNBC. Market fundamentalism led to the movement to privatize government services, and was instrumental in giving poor advice to the Transition Economies (those Eastern European economies that were once part of the Soviet Empire) and LDCs during the 1990s and is still espoused by international organizations such as the World Bank and the International Monetary Fund (the IMF). Market fundamentalism is a modern version of the old doctrine of "Laissez Faire" – leave (markets) alone. It is also a version of the "invisible hand" doctrine usually, but erroneously, attributed to Adam Smith (see the quote at the top of this Commentary and note 5 below).

4. However, this view of how markets work is not supported by economic theory, and does not apply to the US or any other real economy. The theoretical "market economy" that economists study (which I will simply call the Arrow-Debreu model of general equilibrium) is a "toy model" that assumes (among other things) that the economy

consists of a complete set[12] of smoothly functioning, perfectly competitive markets – one for each good and service.

The Arrow-Debreu model *was designed to show* that it was *possible*, *at least in theory*, that Adam Smith's "invisible hand" could bring about an efficient allocation of the economy's scarce resources, through people pursuing their own selfish interests. However, economists can prove that even this ideal system will only lead to a socially optimal outcome if there are no market imperfections: external effects (CM14) and/or public good issues (CM15) and/or informational asymmetries (CM16). Because all of these problems exist in all real economies, including the US economy, we would not expect that real-world unregulated market systems would necessarily generate socially optimal outcomes. The US economy clearly does not correspond to this theoretical idealized market economy: the 10 largest (by market capitalization) companies in the world in 2018 were IT companies, banks and energy companies; Walmart and automobile and healthcare firms were among the top firms in terms of sales. These corporations are not the tiny firms that have no power to influence the price of their output that economists are talking about when they discuss (perfectly competitive) markets. In addition there are unions and barriers to trade, there is a large government sector, real world markets – especially labor markets – do not smoothly and rapidly achieve equilibrium, and some industries (for example pharmaceuticals and energy companies) have enormous leverage with politicians and use that leverage to get politicians to pass economic legislation that benefits those industries.

5. However, this is *not* meant to imply that there are no problems with the government sector – there are government imperfections as well as market imperfections – bureaucracy, unionized government employees, soft budget constraints,[13] and political intervention that leads to economically inefficient outcomes; for example, in the defense field alone: failure to close unneeded military bases, Congress forcing the military to purchase weapon systems that the military does not want,[14] the coexistence of four

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[12] This means that there would be a market for every possible contingency, including an insurance market to protect you against unemployment. The real world is characterized by the absence of many markets not by a super abundance of them.

[13] Congress may simply give subsidies to, say, the USPS if it makes a loss, and so it is really not constrained by its budget in the way that UPS and FedEx are.

[14] Weapon system procurements that buy "big ticket" items – aircraft carriers, submarines, stealth aircraft, main battle tanks – items that almost always overrun initial cost estimates, are often delivered years after their intended dates to enter service, while failing to deliver effective equipment and armor for the poor grunts who actually die for us.

chaotic payment systems (one for each of the four armed services), inter-service rivalries that are about career opportunities not about strategic needs, and provision of overly generous benefits for some military personnel – colonels who can retire at fifty with handsome pensions and medical benefits. The US military is a huge bureaucracy with a bloated officer corps representing over 14% of the military's total personnel: 3,700 colonels but only 33 brigades, 3,500 naval captains but only 359 ships.[15]

6. Economists often appear to favor the status quo, to be apologists for capitalism; despite the fact that many economists are politically liberal their analyses of issues such as rent control and the minimum wage seem to be anti- liberal because economists point out that these policies are often poorly targeted. Economists routinely point out the advantages of competition and the disadvantages of monopoly and oligopoly where large firms engage in non-competitive behaviors. Economists have been suspicious of "big business" since the days of Adam Smith who wrote that: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." *(The Wealth of Nations* (1776), Chapter X, Part II, p. 152).

7. My view is that economists ignore the possibility that sellers may use their superior knowledge of the properties of the goods and services they supply to mislead their customers. The terms fraud and negligence do not appear in any micro text that I am familiar with. (If you come across one please email me the information.) But misleading advertising, the sale of products that are known to be deficient (even lethal), and failure to engage in due diligence are commonplace in our economy. (Thalidomide, opioids, air bags, emission cheating, and oil spills.) Many examples of malfeasance are the result of single- minded pursuit of profit in real world markets where there may only be a few firms but where competition is fierce. These markets are called oligopolies (a small number of sellers – SUVs) or duopolies (two producers – Boeing and Airbus). Economists assume that competition is a force that will stem "bad" behavior – the stock market will punish the firm – but sometimes this means "shutting the door after the horse has bolted; redress is made after, not before, the fact. If you die then the fact that your relatives are "compensated" for your demise will do little for you.

Competition is a far from perfect mechanism for establishing a socially optimal allocation of resources. There is nothing that requires firms to pursue the public interest, and competitive pressures may cause a firm to engage in perfectly legal practices that cause harm. Economists are well aware of externalities but have ignored other problems with self-interested behavior. Which is **not** to say that all of the 30 million firms in the US are

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[15] The most efficient forces historically had only 3-8% of their strength as officers.

engage in dishonest behaviors; however, it would be naive to believe that none of them do. (I can list over 100 examples of malfeasance in over 30 industries.)

Since government activity is also subject to problems, we must ***treat each case on its own merits*** and avoid blanket statements that claim that only "markets" or only governments are good. Remember that all real policies have some problems and so finding a problem should not preclude adoption of that option, we always need to compare a policy with its alternatives, including the ***status quo***, and evaluate all of their benefits and costs. "The best is the enemy of the good."

http://www.nytimes.com/2014/11/11/business/11-years-later-death-is-tied-to-gmdefect.html?_r=0
http://www.nytimes.com/2014/12/18/us/new-england-compounding-center-steroidmeningitis-arrests.html
http://www.nytimes.com/2015/02/14/your-money/fiduciary-duty-rule-would-protectconsumers-and-target-investment- brokers.html

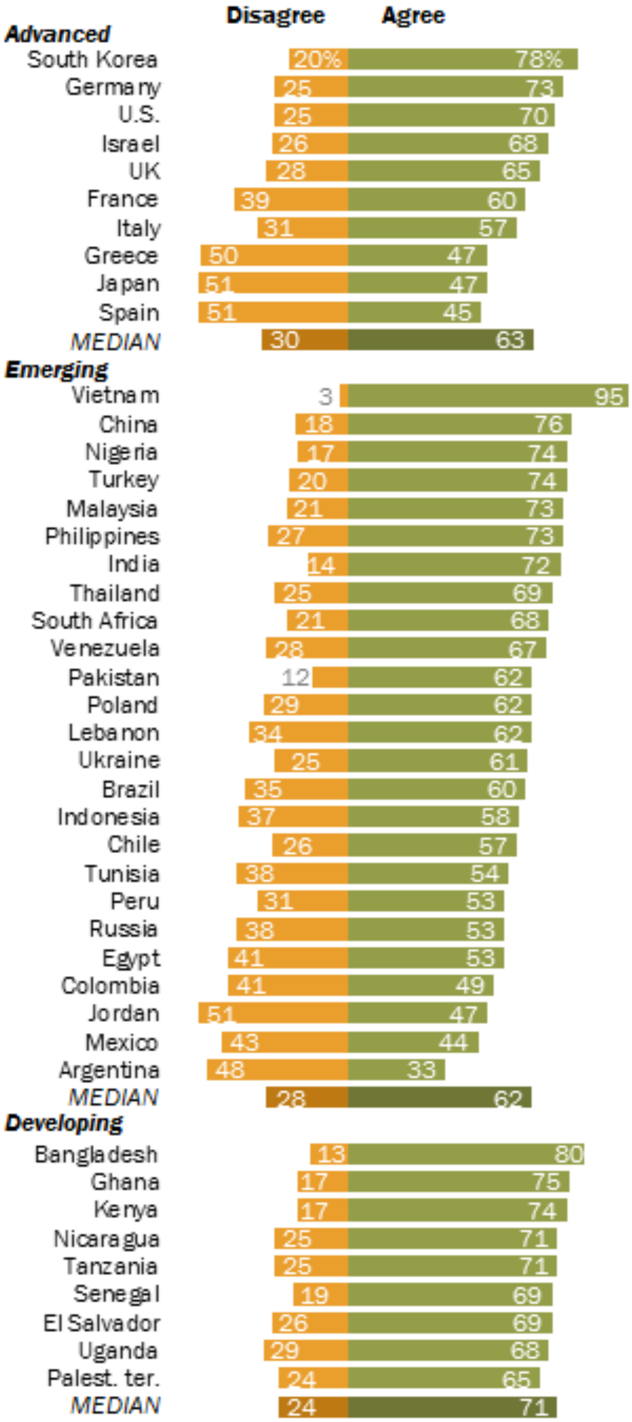
7. Economists, like lawyers, can be hired to come up with arguments to provide ammunition for the policies advocated by powerful business groups, just as some scientists can be recruited to deny the climate change.

8. Here is some interesting data on opinions about the efficacy of markets around the world. I think that what these results show is that among economic systems western style capitalism is the best among a poor lot. The problems of Emerging and Developing economies government corruption is a huge problem and the respondents probably believe that "a free market economy" is one without corruption. The data is interesting: why are there no results for the Nordic countries and Holland? Why are the Japanese less enthusiastic than the other Advanced countries? (Culture?) Notice that Greece and Italy are countries where government corruption is high by Developed country standards.

Notice that people are unlikely to be in favor of "unfree" markets – beware of economists' jargon.

Support for Free Market System

Most people are better off in a free market economy, even though some people are rich and some are poor.



Source: Spring 2014 Global Attitudes survey. Q13a.

PEW RESEARCH CENTER

4. BACKGROUND

An interesting feature of standard economics courses is that they are ahistorical, they treat economics as if modern advanced economies had always existed and how they evolved into their present form is of no interest. This is a view I held for most of my academic life but that I now believe to be mistaken. To understand the US economy in 2021 it is useful to have some idea of how it took its present form. Unfortunately, *I am not an historian, economic historian, political scientist, anthropologist, or sociologist so treat the next paragraphs with even more than your usual skepticism*. I am making this up as I go along. Just read through this section, I will not examine you on this material, which could be wrong! You may know more about this section than I do in which case please enlighten me.

THE GOOD OLD DAYS

10,000 years ago – give or take a week – our ancestors started to domesticate plants and invented agriculture; they were able to grow enough food to start towns and villages and accumulated enough stuff to make banditry and warfare easier than a solid day's work. About 9,000 years ago our ancestors started to domesticate animals – horses, cows, oxen, sheep, pigs, chickens.

There were three social classes or castes. (1) The military provided the kings and made up the aristocracy. Warriors need to start learning how to handle weapons by the time they are six years old, need to train all of the time, and have very expensive equipment and horses. (2) The clerics/priests who were literate and able to run the administration, and (3) the proles who did the work. There were slaves since humans have been enslaving one another once we became "civilized" – slaves were usually defeated enemies. As the size of the market increased there were also merchants, shopkeepers, artisans.

At the height of Greek civilization, around 2500 years-ago some of the merchants had become very wealthy. Being a merchant was risky and risk has to be rewarded by high returns. Fortunes were made in real estate, by lending money at interest, and engaging in foreign trade. The aristocracy earned rents from the land that they owned. The proles subsisted.

Over time merchants and manufactures became more important but the basic social structure did not change very much.

CAPITALISM

Then around 1760 the English and Scots started to make technological innovations – the Industrial Revolution. People migrated to the towns as agricultural improvements meant that fewer people were needed in agriculture and agricultural output increased so that larger urban populations could be supported. But the industrial revolution ushered in a major economic change, capitalism.

Capitalism is an economic system that grew out of the need of modern industries to raise financial capital to pay for the physical capital (machines and buildings) that the industries needed to produce their goods. *Private ownership* of property had been commonplace for millennia, it *is not something that is unique to capitalism.* The industrial revolution required *a massive increase in the scale of enterprises*. Canals, turnpikes (roads), railroads, coal mines, the steel and (later) oil industries, factories to produce textiles and other mass-produced goods all required large quantities of physical capital, which required massive amounts of financial capital to finance the purchase, operation and maintenance of the machines and buildings. Entrepreneurs (Carnegie, Rockefeller), who were able to raise the capital were the capitalists and they employed the labor force, the proletariat, to operate the factories etc. Capital tends to grow – think of the effects of compounding in a profitable industry growing at, say, 10% per year: your capital doubles in 7.2 years, quadruples in 14.4 years, increases eightfold in 21.6 years. If you reinvest rather than spending all of your gains you can become very wealthy in a lifetime. Of course, if you invest badly then you may lose everything.

Capitalism rewards entrepreneurs and those who save and invest in other people's entrepreneurship. But capitalism is an economic system that is likely to lead to an unequal distribution of wealth. Over time capitalism developed institutions that made financial investment less risky, for example, the idea of limited liability that developed in the nineteenth century. Today it is possible to invest in Microsoft via mutual funds. Modern financial institutions have lead to an economic system that could not have been imagined by Adam Smith.

Capitalists are able to use their financial strength to influence politicians to avoid regulation. Child and women's labor laws were resisted by employers.

One aspect of economic life that has remained constant over 10,000 years is that most people who only have their labor to sell, the proles, are at the bottom of the economic ladder.

MARX

"Workers of the world unite!" Karl Marx and Friedrich Engels *The Communist Manifesto*, 1848. This was the official motto of the Soviet Union.

"The history of all hitherto existing society is the history of class struggle." Karl Marx and Friedrich Engels *The Communist Manifesto*, 1848

"From each according to his ability, to each according to his need." Karl Marx *Critique of the Gotha Program*, 1875

When I was an undergraduate, back in the Stone Age, I read parts of the first of the three volumes of *Das Capital*. I can remember being *very* bored by what I read! It is, was the English would say, not my cup of tea. I never believed in the class struggle: We used to sing a parody of *The Red Flag* (the tune is O Tannenbaum):

The working class can kiss my ass,

I've got the foreman's job at last.

COMMUNISM

Just as there are two sorts of novels, "War and Peace" and all the rest, so there are two sorts of economies: Communist and all the rest.

Communism is supposed to be based on Marxism but the Soviet Union never claimed to be a communist state (the USSR was a self-proclaimed Socialist economy) because the communist party had to organize things until the proletariat (that's you lot, the proles) were capable of ruling themselves. That never happened in the Soviet Union and has not yet happened in China and seems unlikely to happen in my lifetime.

Communism is a system in which the government owns the means (factors) of production – the state owns almost all property except for people's clothing, books, furniture, and other small items. Of course, the government is supposed to use state property for the good of the people. (Beware of anyone who claims to be representing or working for "the people". Beware of anyone who claims to be representing anyone.)

It is important to distinguish between (1) Marxism/communism, (2) centrally planned Stalinist command economies, and (3) socialism. American politicians, at least those on the right of the political spectrum, have a tendency to conflate these different systems.

Marx was very vague about how a communist system would actually work – everyone would suddenly stop being greedy and would pursue the general good. Marxist economics doesn't seem to have a good grasp of the problem of scarcity. Marx, who was as much a sociologist as an economist, declared that capitalists and workers were distinct social classes with the capitalists exploiting the workers, class warfare. Warren Buffett pointed out that: "[T]here's been class warfare going on for the last 20 years, and my class has won. We're the ones who have gotten our taxes reduced dramatically."

https://www.washingtonpost.com/blogs/plum-line/post/theres-been-class-warfare-for-the-last-20-years-and-my-class-has-won/2011/03/03/gIQApaFbAL_blog.html

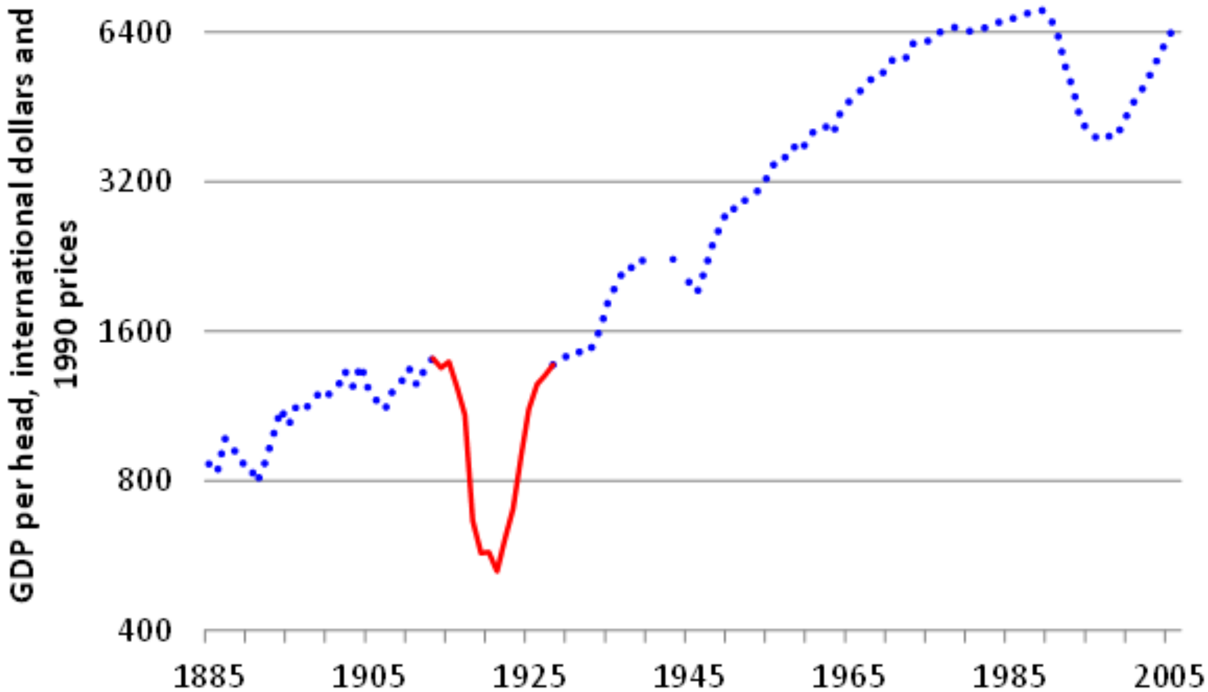
In 2021 there are very few Marxist economists, indeed, very few Marxists except in universities.

Russia lost WW1(1914-1917), had a huge revolution, (1917) and then had a vicious civil war (1917-1922) – Britain and the US sent troops to Russia to fight on the side of the White Russians. The Soviet Union was a "war economy" from 1917-1922. By early 1921 it was obvious to Lenin that the war economy was a disaster. He introduced his New Economic Policy in which the state would own and control the "commanding heights of the economy" (essentially heavy industry, transportation, natural resources and trade) the rest, especially agriculture, would be turned over (temporarily) to the private sector. This was "state capitalism". Lenin died in 1924 and Stalin – the ultimate control freak and along with Hitler and Mao one of the three most evil people in the twentieth century – ousted Trotsky and instituted central planning (five-year plans) and collectivization of agriculture.

It is this Stalinist, centrally planned, version of communism that people traditionally think of as communism, and which was adopted in Mao's China and many ex-colonial states in Asia and Africa and imposed on the members of the Soviet bloc, such as Hungary, Poland and Czechoslovakia. The ex-colonies in Africa and Asia were impressed by the feats of the Red Army and the industrial growth in the USSR during and immediately after WW2, and even more impressed by the Soviets getting into space ahead of the US.

Currently North Korea and Cuba are probably close to Stalinist Communism, central planning.

It is generally agreed that the 70 years of communism in the Soviet Union was an economic disaster. The system collapsed in 1989 and the Soviet Union was dissolved. Russia, badly advised by western – largely American – economists ended up in a massive recession and under Putin as a Kleptocracy.



The figure shows real GDP per head in the Soviet Union and post-1991 the Russian Federation. Note that the Tsarist Russia was doing relatively well until 1917 and also the huge drop in living standards in Russia after the collapse of the Soviet Union in 1991.

SOCIALISM

Socialism *originally shared with communism the idea that the "commanding heights" of the economy should be publicly owned.* But *modern socialism*[16] – the ideas espoused by Social Democrats in Europe – has dropped this idea and *is largely concerned with what is the appropriate role of regulation of economic activity. Modern socialism aims for an economy that takes advantage of markets while curbing their excesses.* Social Democrats favor policies that emphasize care of the old and the young and those who are disadvantaged in various ways, and the provision of universal health care, education, and social services. Income and wealth inequality are major concerns to Social Democrats. Taxes are higher on average and more is spent on public goods.

[16] In the US socialism is often equated with communism, that is, Stalinist central planning. (Keynesian macroeconomics is also tarred with the same brush – creeping socialism). In Europe many political parties that would regard themselves as being conservative lie to the left of most Democrats.

Government regulation of the environment and global warming are more common concerns than in the US.

In America communist and socialist parties never had the following that they did in Europe, even in the depressed 1930s. There was great concern, even among the working classes, that socialism would mean the state stealing people's private property. The Soviet Union under Stalin was a military threat to the US and Western Europe during the Cold War, which did not endear its economic policies to Americans.

5. ALTERNATIVE ECONOMIC SYSTEMS.

1. As we saw in CM1 resources are scarce. Therefore, all societies must make choices about how to use or allocate their limited inputs, given their fixed (in the short run) stock of technological knowledge. All economies must solve *three resource allocation problems*: (1) *What* to produce (cars or roads) and in what quantities (1000s or 100,000s), and which qualities (Ladas or Audis)? (2) *How* to produce? Countries usually have access to the same technology therefore their choice of technique is determined by economic considerations – labor-intensive techniques if labor is relatively abundant and cheap (India), capital-intensive techniques if capital is relatively abundant and cheap (US). (3) *Who* receives the goods and services produced? Which may refer to the distribution of income amongst individuals, or households, or the distribution amongst the owners of the different factors of production.

2. Although the US is often thought of as a "market economy" in which resources are allocated by a price system, in reality we live in a "mixed economy" with a large government sector (Federal, state, and local), and where most of the output is produced by firms who have very considerable power to set prices subject to the constraints placed upon their profits by the fact that quantity demanded is inversely related to price.

4. There are four basic approaches to resource allocation (solving the problems that arise from relative scarcity).

1) *Tradition and custom*: what your parents did and your grandparents and each generation before them, has been the dominant factor in human history[17] because once you have discovered a way that works it is extremely risky to experiment with new ways that may turn out to be disasters. There is a huge difference between going bankrupt

[17] What gets planted and where and when and by whom? Who receives different parts of the deer killed in the hunt? These systems are very conservative; a bad innovation may cause you to starve.

and starving to death. Today this is probably only important in the least developed economies.

(2) *Market systems*: where market forces set prices. The prices act as signals and profits and losses act as incentives to respond to those signals. Market systems are characterized by the dominant role of private property; they require well – defined property rights and the means to enforce them.

(3) *Command economies and central planning*, where resources are allocated by *political* decisions. Command economies are characterized by public ownership with only limited private property. Resource allocation is determined by a complex set of top down plans that are very inflexible, and the planners determine prices with almost no attention to consumer preferences. Command economies use prices to allocate scarce resources, but they don't let market forces determine those prices.

(4) *Mixed economies* that rely on prices to determine much of resource allocation but also have large government sectors and where the government interferes in resource allocation to regulate market activity and to provide subsidies and incentives to firms sometimes simply to garner political support for the politicians who make the government decisions. Mixed economies are the dominant form of economy in 2021 – see 6 below.

5. Pure market systems and pure command economies lie at the extremities of a spectrum of economic systems that span a range of alternatives, with market economies on the left of the spectrum and command economies on the right. (See Figure 1.) But since the dissolution of the of the Soviet Union on December 26th 1991 there has been a worldwide movement away from central planning and towards systems in which markets play a major role in resource allocation. In recent years some countries in Latin America have elected populist regimes that are democratic only in the sense of having elections (sometimes rigged) but failing to respect the rule of law and the freedom of the press. Venezuela, ostensibly a socialist state, is a country that is suffering from massively incompetent economic management.

6. *Almost all current economies are mixed capitalist economies* and lie in the middle of the spectrum. We have various types of capitalism – including Chinese State Capitalism, American Corporate Capitalism, and Russian Kleptocratic Capitalism.[18] Cuba is closer to

[18] Kleptocracy (rule by thieves) is certainly much more common in the twenty-first century than custom. Not only Putin's Russia but also many of the ex-Soviet economies are effectively Kleptocracies, as are many LDCs.

the command end of this spectrum. Many LDCs – India before 1990s, many post-colonial African economies – adopted Soviet style economic planning when they got rid of their colonial masters. In the 1980s Prime Minister Thatcher and President Reagan successfully undid much of the social safety net and privatized many economic activities that were formally run by the government, not always successfully.

https://www.boredpanda.com/corporation-economies-explained-cows-ecownomics/?utm_source=search.yahoo&utm_medium=referral&utm_campaign=organic

7. The "Nordic model" – Norway/Sweden/Denmark – has produced a seemingly successful blend of markets and strong governments; Norway has one of the highest standards of living in the world and also some of the highest tax rates and an extensive social safety net. But there are huge differences between the ways that Scandinavians and Americans view the world and I think that the possibility of the US adopting anything like the Nordic model is extremely remote. (It is interesting to see the differences between how the US and the Nordic countries and Holland have dealt with the Pandemic – they have attempted to maintain their economies by paying wage subsidies to their unemployed that account for about 80% of lost incomes.)

Most European countries have larger government sectors and more government intervention in the economy than the US does.

8. The Russian Federation is difficult to classify – it is what I mean by a Kleptocracy (a system in which the people with political power use that power to enrich themselves (steal)). Although Russia uses prices to allocate most goods and services, the state has recaptured much of the natural resource base of the Russian Federation – huge quantities of oil and natural gas, badly managed.

Property rights are extremely insecure, with state intervention that changes the rules under which firms operate, often quite arbitrarily. Service seems not to have improved much since the fall of the Soviet Union. The western part of the Russian Federation is industrialized and has many of the characteristics of an advanced industrialized economy, but east of the Urals there is much poverty and that part of the economy is more like an LDC. Russia is very dependent on exports of oil and natural gas and would be adversely affected by large decreases in energy prices. Many of the ex-members of the Soviet Union have economic systems that mirror the Russian one.

9. China is also difficult to classify. Like Russia the PRC is what I would call a dual economy, with the eastern coastal areas highly developed with most of the characteristics of a capitalist/market economy, while the central and western regions are more like an LDC. The Communist party, and the Chinese military (the People's

Liberation Army) play a major role in resource allocation. Like most LDCs and totalitarian systems corruption is a major problem and property rights – at least in the countryside – are fragile. The President of the People's Republic of China and general secretary of the Communist Party of China, and chairman of the Central Military Commission, Xi Jinping, has waged an anti-corruption campaign (but cynics might interpret his actions as a covert way of tightening his hold on the party). China is still a one-party state and is about to celebrate the 100th anniversary of the founding of the Chinese communist party. Modern China is very much an autocracy.

10. China and Russia have had almost no experience of democracy. (Democracy was not a feature of most historical states.) The Tsar owned everything in Russia. The Chinese Emperors were often in a similar position. Democracy is a system that needs time to develop – there is little point in declaring elections (a very American interpretation of democracy) if you do not have developed political parties. (The Icelandic parliament first met around 930 CE.) Elections are important but so is the rule of law, freedom of the press, transparency.

11. The US is largely a market-oriented economy, but there is still a large government sector and considerable government regulation (which is being eroded by the current Administration), and serious problems associated with the influence of interest groups.

6. MARKETS VERSUS COMMANDS.

1. *Market* (capitalist) economies are characterized by *private ownership of property*, what economists call *property rights*. *Command* economies are characterized by state ownership of land and productive enterprises. In a command economy you own your clothes, household possessions, and cars (if you can get them and they are probably not very good cars). *If you don't own something you have poor incentives to look after it*: *40%* of the agricultural output of the USSR was produced from the *4%* of the land that was privately farmed, the 96% of the land that was farmed collectively only produced 60% of the USSR's agricultural output. Enforceable property rights are a crucial component of a market system. Establishing title to land is often a major problem in LDCs. The economic reforms of Deng Xiao Ping were a reaction to a small group of farmers who started to farm for themselves.

2. In a capitalist or market economy resource allocation is primarily determined by prices that are in turn determined by supply and demand; these economies are highly decentralized. Command economies are very centralized and political processes determine resource allocation. Planners – central planning – set prices. Soviet prices were amazingly rigid because it was so difficult to re-compute them in a consistent fashion

and so the planners avoided changing them.[19] Between 1954 and 1990 the price of bread was constant. By 1990 the price of bread covered only 7% of its cost of production – boys cut hockey pucks from frozen loaves, farmers fed their pigs on bread. For the whole period from 1962 to1990 meat prices were constant. This led to excess demand and much wasted time waiting in line. The time spent queuing was an implicit cost of the item and so prices were higher than the low explicit costs suggested. In the USSR there were "black" markets for almost everything.

3. Markets involve consumers directly in economic decisions but Command economies largely ignore consumers' preferences. Command economies have huge information problems especially concerning what consumers want to buy. Industrialization (building steel plants) and wars [20] involve relatively simple decisions and there is little need to consider consumers, but peacetime decisions become more and more difficult as the economy becomes more developed and consumption becomes more important. Examples: only black cotton thread in Moscow and only white in Kiev (Kjev); the poor quality of housing in Soviet Union; the awful state-produced Lada automobile.

http://www.dailymail.co.uk/news/article-2130942/Lada-Russia-announces-endmanufacturing-ridiculed-car.html

But economies in which the government has a major role in resource allocation may be good at pursuing IT and AI and space exploration; although when they make mistakes the consequences are likely to be massive. (China delayed announcing the outbreak of the virus but was also able to quarantine and shut down the affected parts of the economy more efficiently than the US – but less well than New Zealand a capitalist democracy.)

4. *Asymmetric incentives: Markets use "carrots"* (rewards); market economies bribe people to do unpleasant or dangerous tasks or to live in unattractive places. *Command economies rely on "sticks"* and punishments. The psychological literature and economic experience show that positive incentives are very much more effective than negative ones. If you don't own something then you have no incentive to look after it.

5. *Efficiency.* Because of their better incentive structures market systems are clearly economically more efficient than command systems. Consider the contrasts between North and South Korea, East and West Germany all four of which started with about the

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[19] It has been estimated that there were over 500,000 prices to be set by the central planners. Adjustment of any one of them entailed adjusting thousands more if the prices were to be consistent. It was much simpler just to set supply targets.

[20] The US economy was carefully regulated and subject to price controls during WW2. During wartime rationing, as well as prices, is used to control demand.

same very low standard of living after WW2, but the market-oriented economies grew successfully and the command economies stagnated or even regressed.

6. There is a *lack of innovation and initiative* in command systems – why bother to develop a new idea if you do not benefit from your ideas?

7. *Quality and service* were appalling in USSR because you got paid the same whether you did a good or a bad job and manufacturers were not subject to competition and so could ignore the demands of their customers

8. Markets use *voluntary exchanges*; command economies *have to **enforce** involuntary exchanges*. Command economies must have the ability to coerce the recalcitrant; therefore, *command economies have an inevitable tendency to turn into totalitarian regimes*. Cuba under Batista was an awful regime, but were Cubans freer under Fidel Castro?

9. Command economies allow setting national economic priorities – the Welsh socialist Aneurin (Nye) Bevin said: “socialism is about priorities”. You would therefore expect that command economies would do better at dealing with environmental and natural resource problems but they have appalling records in this area, and you would expect that they would have “better” income distributions but there is a huge difference between what you are nominally paid and your access to economic resources (housing, cars, foreign luxury goods, and the health system were all areas in which party members and "apparatchiks" received favorable treatment – tickets to the Bolshoi), and infrastructure is much worse in command economies than in capitalist ones.

10. *Market economies are not one person, one vote, systems*. Economic power can be used to tilt the playing field in directions that economic elites like. (9,464)