

Reading 2

Types of Economic Systems

I. The Three Basic Types of Economic Systems

There are three basic types of economic systems – a freely, self-organizing system (minimal government), a command system (maximal government), and a mixed system. The three systems have all been used to some degree or another throughout history. They continue to be used today. Mixed systems have proven to be the best type.

The self-organizing system is the most natural of the three economic systems since it is a spontaneous, self-evolving economic system. However, this system evolved from very small societies composed of families that banded together to survive. Living alone brutally subjects individuals to the so-called "state of nature". Thomas Hobbes (5 April 1588 – 4 December 1679) discussed this state of nature in his famous book *Leviathan*.¹ The state of nature is a primitive, individual struggle to survive without the benefit of society or government. To escape this state of nature requires that we give up our hostilities towards each other, thus finding peace in society. Over time this society becomes ordered by convention, consensus, and tradition. Specializing in production and then trading amongst one another is a perfect example of how economics promotes peace. In small societies, free trading is a strong unifier. People adopt social contrivances such as a common form of money, a common form of language, and common trading laws. Those who disobey the rules and customs are excluded from the group and this is costly. There is little central authority in these small free trading societies since people already realize that consensus promotes stability and safety, the maintenance of which is in their own self-interest. Also, to consume, people learn that they must be productive. This promotes a responsible attitude towards being productive and trying to supply what most people want. Competition is allowed, but not violence or coercion. Competition and success as a supplier requires adoption of common rules and customs. One extremely important custom involves the development of property rights. Private property and the rights of people to transfer their

¹ Hobbes was a royalist and supported the monarchy as the preferred government. He did this in part because ...

“Now in monarchy the private interest is the same with the public. The riches, power, and honour of a monarch arise only from the riches, strength, and reputation of his subjects. For no king can be rich, nor glorious, nor secure, whose subjects are either poor, or contemptible, or too weak through want, or dissension, to maintain a war against their enemies; whereas in a democracy, or aristocracy, the public prosperity confers not so much to the private fortune of one that is corrupt, or ambitious, as doth many times a perfidious advice, a treacherous action, or a civil war.”

Compare this with modern day North Korea or the old Soviet Union. Would you agree with Hobbes?

property to other hands without intrusions by some higher authority is an essential part of a freely organizing (market-based) economy.

However, just as it is possible to self-organize into free trading households, it is also possible to form large armies and simply take property. Naturally, a rich and powerful centralized authority can protect one from this and so this led quite naturally to the formation of kingdoms and fiefdoms. Property was expropriated by the king and granted to lower levels of royalty. A feudal system arose that produced landed rulers (lords) and landless workers (vassals). The feudal system held together by coercion, the need for armies, personal relations, religion, and always by the benefit of protection. The feudal system was governed by crude laws, customs, traditions, and coercion. Throwing off this feudal system was one of the most important (abstract) periods of history. The European feudal system continued up until the 15th century although Magna Carta (15 June 1215) had of course already won some rights for people and self-government. The French Revolution (1789 to 1799) and later Napoleon (1769-1821) were major forces in changing the feudal structure of Europe. But, these movements did not solve the issue of government. People still needed a government to provide the five functions discussed in our first reading.

Minimalist government systems were proposed by many people in history. Anarchists such as M. Bakunin in Russia believed it might be possible and indeed optimal to allow freely organizing societies and productive efforts to form². A less radical (and non-socialistic) approach is libertarianism, which takes individual freedom and personal responsibility as its keystones. It is opposed to the use of force or coercion, the commission of fraud, and to the existence of monopoly. It sees the role of government in the simplest and barest forms, mainly as providing pure public goods that are impossible to produce in private markets.

In contrast to anarchist and libertarian systems, strict monarchies and dictatorships (both individual and party-based) are important examples of maximalist systems. These are the command economies. The ruler owns all enterprise, all as well as all productive factors, of the country. Pricing is done via commands rather than market pricing. The most obvious examples of this system are the communist command economies. We will not study comparative systems here, but we can recognize that neither minimalist nor maximalist economies have been very successful at generating high and growing per capita standards of living. The usual response to this is to assert that these systems have either not yet been tried (wrong) or have been more effective at securing equity and justice (wrong again). In this regard, I think there is much truth in the statement that “countries that have emphasized equity over efficiency have generally ended up doing worse on both accounts”.

² **Anarchism** is a political philosophy that advocates self-governed societies based on voluntary institutions. These are often described as stateless societies, although several authors have defined them more specifically as institutions based on non-hierarchical free associations. Anarchism holds the state to be undesirable, unnecessary, and harmful (from Wikipedia). **Libertarianism** (Latin: liber, "free") is a collection of political philosophies and movements that uphold liberty as a core principle. Libertarians seek to maximize political freedom and autonomy, emphasizing freedom of choice, voluntary association, individual judgment, and self-ownership (from Wikipedia).

This means that mixed economies are preferable to either maximalist or minimalist economic systems. If this is true, then how do we decide how much of the economy should be in the hands of government? I think it would be wise to consider briefly the history of the US Constitution to shed light on this.

II. The US Constitution as a Rich Source of Political Economy

The essential question confronting the early political thinkers in the US was how to construct a government strong enough to be efficient, protective, and productive, but nevertheless detached enough to give power to the public to live freely and without the threat of intrusion by government. What was the best mix? Clearly, a strong central government is dangerous, but a weak central government is just as useless, as well. This issue is a true conundrum.

James Madison wrote in the famous Federalist paper #51

"But what is government itself, but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, **the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.**" (my emphasis)

I suspect we will not do much better than Madison in describing the problem. Do not expect a fascist (who believes in a single dictator) or a communist (who believes in a party dictatorship) to agree or even understand Madison. Such people are modern day Hobbesians.

After elucidating the problem so well, James Madison proposed a solution, which was to create a system of checks and balances. These would allow government to be powerful in total, but would disperse the power among branches (executive, judicial, and legislative), each of which would jealously guard its own power. To achieve vitality and change in government, the public would hold periodic elections. To achieve stability in government, the public would create positions filled by appointment to long terms and rightly confirmed by those elected. To tame the violent tendencies of government, the public would place the military under civilian control. And, most importantly a constitution, which would specifically and transparently *enumerate* all rights and powers of the government, allowing all other powers not enumerated to revert back to the people (or the lower level states).

The US today is a mixed economy, like most advanced economies in the world. The government plays an important role in the economy. However, the federal government is limited in how it can interfere with the economy. This is because of the enumerated rights and powers granted the federal government in the Constitution.

[See Richard Epstein on the Classical Liberal Constitution \(warning-very complicated\)](#)

Careful study of the US Constitution, as it relates to economics, is an excellent way of learning political economy – perhaps the best way. This is because the Constitution was crafted to deal with the complicated interface between politics and economics. The study of the Constitution reveals a need for both theory and empirical evidence. It requires one to be practical and because it is often seen through the prism of historic cases argued before the Supreme Court, it is necessarily applied and practical. It is the real-world judgments of the SCOTUS that force us to be practical and clear about what we are discussing. This does not mean that all judgments rendered by the Supreme Court are free of prejudice and poor reasoning. Many of the judgments are the product of the prevailing prejudices of the times during which they were considered. Yet, much can be learned about political economy by studying the Constitution and its interpretations. Listening to Richard Epstein in the link above gives you the feeling of what a real scholar in political economics should aim to achieve.

III. Empirical Aspects to the Size of Government in the Economy

The Constitution tries to define the limits to government. However, the Constitution is not always clear about the nature of these limits, how large they are and what form they take. There are always arguments and controversies about this. One solution to these controversies is to observe how well some countries do relative to other countries and compare the size of their government sector.

As the diagram below shows, for the world on average government current expenditures as a % of GDP is about 17%. Of course, governments also make public investments and make transfer payments, but these expenditures are not included in the World Bank's figures shown in the graph. The graph shows only consumption or administrative costs of the state. This figure has risen from about 13.5% in 1960 to its current level of about 17%. Note also that since the mid-1970s the % has not changed by much. This means that the real value of the administrative state has been growing along with the GDP at about 3% year for the world.

How do some of the advanced economies stack up against the world in general?

The second graph below shows three countries – the US, China, and Japan. China's administrative state has been growing faster than its economy since 1960. The growth was uneven though. It is now roughly the size of the US in terms of % of GDP. Japan has had incredible growth of government after 1990 – a time that saw its economic growth falter. Much of Japan's growth in government is probably due to the tremendous ageing in its society and its social safety net.

Figure 1

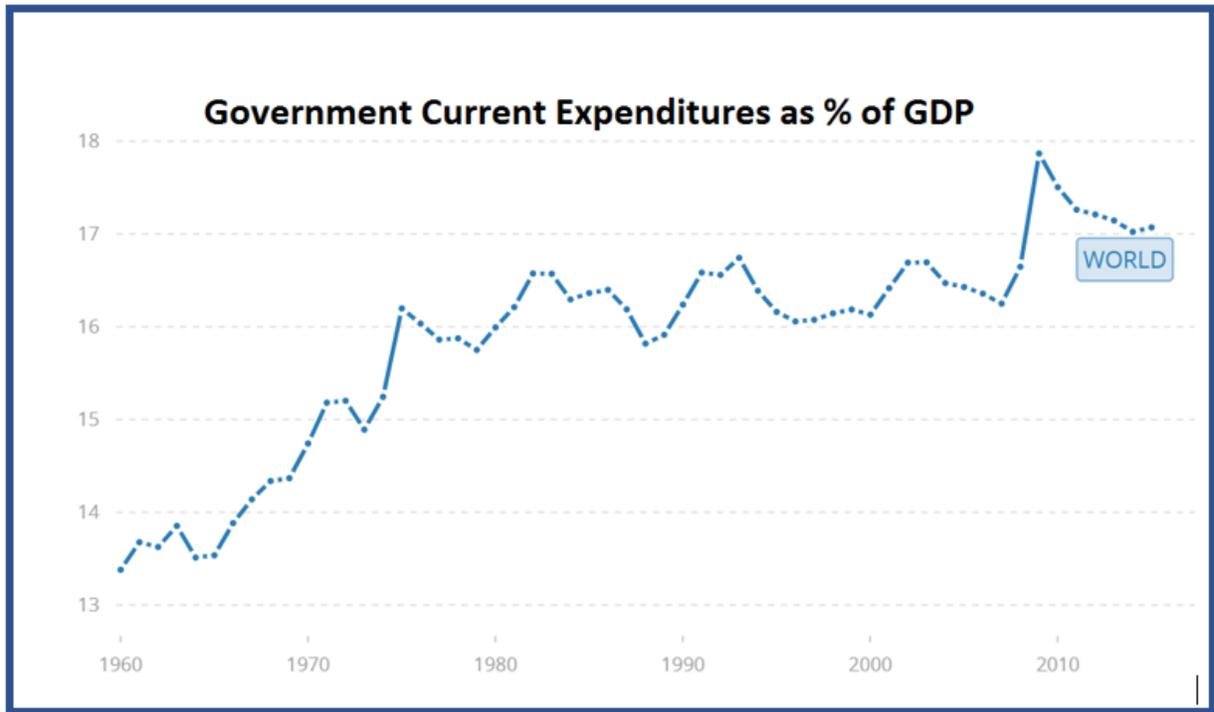
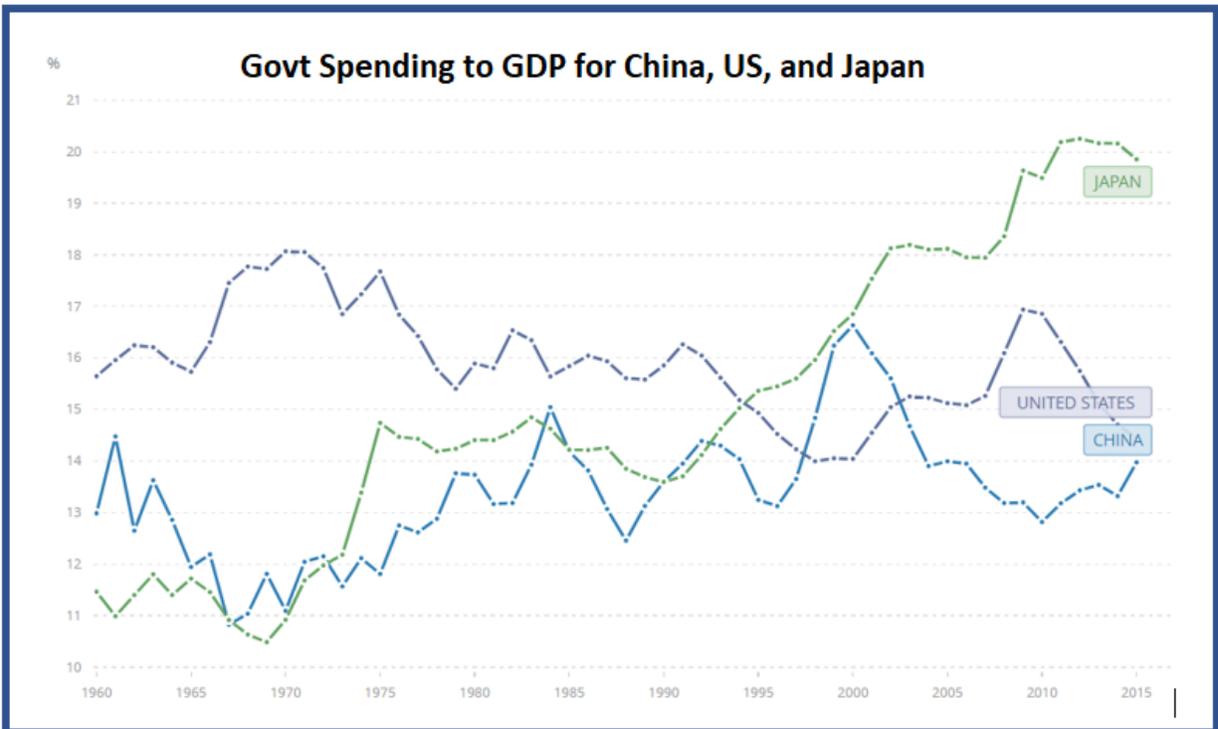


Figure 2



Of course, two graphs cannot tell us much about the issue of government and growth. However, more elaborate studies of growth and the size of government have been undertaken. This is always a popular topic especially among conservative think tanks. A study in 1998 by the Joint Economic Committee of the US Congress found that the size of government could have negative effects on growth. This is especially true if one considers the impact of large transfer payments – something that we have said may be behind Japan's big slowdown. You can read the study [here](#). Even so, it is not at all clear why that big government is always bad. For one thing, we see rich countries usually have a very high public administrative sector. Whereas, poorer countries usually have lower sized administrative sectors. Perhaps as countries become richer they tend to use government for reasons other than purely to drive the economy.

Questions:

- #1. What types of minimalist government systems are there for the economy?
- #2. What type of maximalist government systems are there for the economy?
- #3. Socialists like big government because big government can do big things. Criticize this.
- #4. Capitalist believe that government is not really needed so much. Criticize this.
- #5. Why is it difficult to determine how large the government should be in our economy?
- #6. Confucius is reputed to have said that you can tell a good government from a bad government by looking whether people want to go to the country. Explain the simple logic of this. Is it true?
- #7. Command economies like North Korea are usually very dark and dreary offering only one choice for clothing, cars, etc. Why do command economies offer only one choice? Why not greater diversity?
- #8. Market economies have advertising. But, do people really need advertising in life. Isn't it a big waste of resources? Aren't companies merely fooling people into buying their products?
- #9. The big problem about market economies is that they have profits. Profits are evidence that labor has been exploited. What are the functions of profits?
- #10. Big corporations do not care about the public. It would be better if all large corporations were nationalized and run by the government, since government cares more about the public. Agree or not agree?

General government spending Total, % of GDP, 2007 – 2015

