1 How Do We Compare Economies?

As mankind approaches the end of the millennium, the twin crises of authoritarianism and socialist central planning have left only one competitor standing in the ring as an ideology of potentially universal validity: liberal democracy, the doctrine of individual freedom and popular sovereignty. . . . In its economic manifestation, liberalism is the recognition of the right of free economic activity and economic exchange based on private property and markets.
—Francis Fukuyama, *The End of History and the Last Man,* 1992

INTRODUCTION

We have witnessed a profound transformation of the world political and economic order since 1989, the ultimate outcome of which is difficult to foresee. The former Soviet Union (FSU)[1] broke up, its empire of satellite states dissolved, and most of the former constituent parts are trying to fulfill Fukyama's prophecy quoted above. In his view, the end of the Cold War means the convergence of the entire world on the American model of political economy and the end of any significant competition between alternative forms of political or economic systems.

Has this prophecy come true? We think not. Certainly during the second half of the 1990s, the economic boom in the United States pushed it forward as a role model that many countries sought and still seek to emulate. But with the outbreak of financial crises in many parts of the globe and the bursting of the American stock market bubble in March 2000, its economic problems such as continuing poverty and inequality loom large.

Furthermore, it is now clear that the problems in the FSU are deeply rooted, with the transitions in various former Soviet republics stalled. Other market capitalist economies, such as the world's second largest, Japan, have deep problems of their own, with Japan's having stagnated since 1990.

Furthermore, the collapse of Soviet Communism coincided with a surge of missionary activity in the formerly Soviet Central Asian republics by advocates of fundamentalist Islam. They present their view not just as a change in personal moral codes, but as a total system of economic and political organization of society, a possible "third way" between capitalism and socialism. Throughout the Islamic world, fundamentalist groups either have taken control of governments or are the leading opposition to existing governments. The terrorist attacks on New York City and Washington, D.C., on September 11, 2001, and

1. Prior to 1917 the Russian Empire included many nationalities ruled by the tsar. With the Bolshevik Revolution, several nationalities gained independence, some permanently, like the Finns and the Poles, and some only briefly, like the Ukrainians. Then there was Soviet Russia. In 1922 it became the Union of Soviet Socialist Republics (USSR) or the Soviet Union, which ceased to exist at the end of 1991. Now there is a loose confederation of 12 of the former 15 republics of the USSR called the Commonwealth of Independent States (CIS). When referring in the present to all of the 15 republics as a group, we shall use the term *former Soviet Union (FSU).*

the subsequent war in Afghanistan made the entire world aware of the seriousness of this global movement. Even after the replacement of the Taliban regime by the U.S.-backed one led by Hamid Karzai, Islamic rules remain largely in place, with women wearing traditional clothing even in Kabul, the capital city.

In other nations, movements based upon fundamentalist versions of local religions have emerged and become prominent. In East Asia, many see the cultural heritage of Confucianism creating a special economic environment. In India, a Hindu fundamentalist regime confronts Muslim Pakistan in a deep conflict. This appeal to economic systems based on traditional religions is the **new traditional economy,** and it presents a serious alternative on the world stage. Global economic difficulties have been further exacerbated by a series of financial crises that have spread havoc and produced sharp recessions throughout much of the world, including many East Asian nations in 1997, Russia in 1998, and the collapse of Argentina in 2001. These crises have aggravated the deeper systemic crises that many of these economies are experiencing.

In *The End of History and the Last Man,* Fukuyama recognizes that the rise of Islamic fundamentalism constitutes a potential exception to his thesis, but responds that it will be limited to the zone of existing Islamic predominance, thus ruling it out as a "potentially universal ideology." But the spread of Islam in Europe and other places raises doubts about this claim. However, the emergence of similar movements within other religions raises the possibility that the new traditional economy concept could be universal even while differing in significant details across religions. Cold War has given way to Holy War.

Even if Fukuyama is right that the socialist alternative will completely die out and that religious fundamentalism will be limited in its appeal, economic tensions between the United States, Japan, and Western Europe have focused attention on deep structural differences between these and other market capitalist economies. There are many varieties of market capitalism, and as various economic problems continue to plague the world economy, the significance of these differences increases and the global search for efficient and humane economic systems accelerates. Many countries sought to emulate some aspects of the Japanese economic system, but now Japan is in deep stagnation. Western Europe and Japan resist the homogenizing influence of the United States and the pressure to imitate its system, with its comparatively greater economic inequality and insecurity. These divergent economic tendencies have been exacerbated by political tensions that have arisen between the United States and many of these nations since 2001.

Indeed, the socialist alternative continues both as an existing system and as a possibility in some form still unseen. Classical socialism in its purest form persists in relatively obscure countries such as North Korea and Cuba. But despite the general dismantling of central planning bureaucracies, legalization of market activities, and privatization drives, portions of the FSU remain effectively socialist in the sense of widespread state ownership of the means of production. In China, the most populous nation on earth, a grand drama is unfolding as the system remains officially socialist while engaging in piecemeal marketization and the spread of capitalism.

Furthermore, even though Yugoslavia has collapsed both as a nation and as an economic system in a horribly tragic way, the idea of workers' management that its economy imperfectly represented persists and may have a new lease on life in the form of workers' ownership. This takes a variety of forms, from the profit-sharing **share economy,**[2] to classic cooperatives, to employee stock ownership plans (ESOPs), all of which exist in the United States and other market capitalist economies and are popular in the privatization efforts of many Eastern European countries.

This systemic turmoil coincides with the intense conflict between the "urge to merge," by which we mean the push for integration of the world economy and its subparts in trade and policy, and the "drive to divide," the push for independence and isolation by increasingly small entities. Also continuing are the deep problems of the less developed countries, many of the poorest of which are in outright economic decline as they search for appropriate systems in this changing environment. These difficulties are further exacerbated by a global stagnation of economic growth that aggravates the systemic crises many economies are experiencing.

Thus, the study of comparative economics has never been more important. The subject itself is undergoing transformation, just as its objects of study undergo transformation. Achieving a deep understanding of this transformation of economic systems depends on understanding the cultural and social contexts within which these historical processes evolve.

CRITERIA FOR CLASSIFYING ECONOMIES

How Do We Classify Economies?

In thinking about the nature of economic systems with the intention to compare them, we need to think fundamentally about what we mean by an *economy.* An economy is made up of a group of people who are located within a political entity that has particular geographical characteristics and who are producing and consuming goods and services. Most important for our perspective, an economy functions according to certain rules, customs, and laws that underpin the institutional framework within which the people operate. It is these institutional frameworks and their basic rules, customs, and laws that we are most interested in comparing across different economies.

2. See Martin Weitzman, *The Share Economy* (Cambridge, Mass.: Harvard University Press, 1984).

There is an endless variety of aspects of these institutional frameworks that can be considered in classifying economic systems. We shall focus upon six that combine and interact with each other in different ways. They are the allocation mechanisms, the forms of ownership, the role of planning, the types of incentives, the method of income redistribution and the nature of social safety nets, and the political and ideological system.[3] However, the first two of these are perhaps the most important in terms of classifying economic systems overall.

Allocation Mechanisms

All economies must answer the questions of "what, how, and for whom" goods and services are produced. Fundamentally, economies produce and distribute goods and services among members of their societies. Production involves allocating factor inputs between different goods and services, and distribution involves allocating produced goods and services among people.

There are three basic kinds of allocation mechanisms: traditional, market, and command. In a **traditional economy** allocation decisions depend on custom, what has been done in the past. Usually such customs or traditions are associated with a broader social context defined by a dominant religion. Economic decision making becomes embedded in the broader social context.[4]

An example is the **caste system** associated with Hinduism in India. Technically illegal since India's independence from Great Britain in 1947, the caste system still dominates both social and economic structures in much of the nation, especially rural areas. The caste system is a system of allocating labor: What one does is what one's parents did, not unlike the system under European feudalism. Each caste has an economic activity and is self-reproducing in that there is a very strong social inhibition against marrying outside one's caste. At the top are the Brahmins, the priestly caste; at the bottom are the Untouchables, who gather dung for fuel and perform other unpleasant functions. Hinduism justifies this

3. An alternative approach is that of Egon Neuberger, "Comparing Economic Systems," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 20–42. He posits four criteria for classifying systems: their decision-making structure, their information structure, their motivation structure, and their coordination system. These can be seen to relate to the categories we use to some extent, with the decision-making structure tied to the political system, the information structure tied to planning or nonplanning, the motivation structure tied to incentives, and the coordination structure tied to the allocation mechanisms—that is, the contrast of tradition, market, and command—although we see the allocation mechanism as being tied to decision making as well, making it a very central concept.

4. Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1944). The earliest traditional economic systems reflect the systems within which the human species evolved as hunter-gatherers, with their balancing of individual interests and group interests through such mechanisms as reciprocity (Eric A. Smith and Robert Boyd, "Risk and Reciprocity: Hunter-Gatherer Socioecology and the Problem of Collective Action," in E. Cashdan, ed., *Risk and Uncertainty in Tribal and Peasant Economies* [Boulder, Colo.: Westview Press, 1990], pp. 167–195).

hierarchy through the doctrine of karma and reincarnation. When one dies, the caste into which one will be reborn is determined by one's karma, one's accumulated account of past good and evil behaviors. Thus everyone is where he or she deserves to be. In a new traditional economy, the effort to embed decision making within a traditional context coincides with an effort to adopt modern technology and to be involved in the world economy.

In a **market economy** allocation decisions are made by individuals or firms on the basis of price signals emanating from the interaction of supply and demand. These signals generally reveal themselves as individuals and firms engage in exchanging money for factor inputs, goods, or services. That such a system can be very efficient is eloquently argued by Adam Smith in his 1776 book *Wealth of Nations*. Every economy ever observed has at least some exchange activity, including tightly controlled command economies such as North Korea and very simple traditional economies such as that of the hunter-gatherer Khoi-San of the Kalahari desert in southern Africa. What marks a market economy is that a majority of economic decisions are made according to market forces rather than tradition or command.

In a **command economy** the most important allocation decisions are made by government authorities and are imposed by law or by force. Command economies were the last of the three forms to emerge historically. They rose in ancient empires such as Sumer and Egypt, which were the first strong and extended states wielding absolute power over crucial economic decision making. There is good reason to believe that the traditional and market allocation mechanisms long predated the command economies of these empires, which date back only 5,000 years.

Forms of Ownership

Karl Marx and Friedrich Engels in their 1848 *Communist Manifesto* argue that the key to understanding an economy is to know who owns the means of production. Ownership determines the distinction between **capitalism** and **socialism,** defined in strictly economic terms. In capitalist economies, land and produced means of production (the capital stock) are owned by private individuals or groups of private individuals organized as firms. In socialist economies the state owns the land and the capital stock.

This explanation attributed to Marx and Engels is simplistic. There are a variety of intermediate forms and cases such as cooperatives or worker ownership. Generally such forms are viewed as still being capitalism, although some argue that they constitute "true socialism." Indeed, aside from the variation of ownership forms, some follow certain ideas in Marx, saying that how one class relates to another is the crucial matter rather than specifically who owns what, with true socialism involving a lack of exploitation of one class by another. This kind of argument can lead to the position that the Soviet Union was not really socialist but a form of **state capitalism** in which the government leaders exploited the workers.[5] We shall adhere to the more standard view that the form of ownership is the key element in defining capitalism versus socialism.

It makes a big difference under socialism if ownership is predominantly by the central government or by local governments. The former is more likely to be associated with command decision making, whereas the latter may coincide with market-based decision making. An example of the latter is China, where there has been a tremendous expansion of firms owned by local units of government that operate in the market economy independently of the central authority in Beijing.

A third possibility is ownership by organized religious groups, which is consistent with a traditional economy system. In parts of Western Europe between 1000 and 1500, nearly one third of the land was owned by the Roman Catholic Church, with major technical innovations being made in abbeys, economically self-sufficient religious communities. In Iran after 1979 under the Islamic Republic, formerly privately owned businesses were seized by religious authorities and remain under their control, if not their formal ownership. Generally the concepts of *property* and *ownership* vary enormously from society to society. These distinctions arise not only from local traditions and practices but also from legal rules and definitions as argued by institutionalist economists.[6]

Considering the division between capitalism and socialism raises the question of the ownership system's relationship to allocative mechanisms. We often see economies that are largely capitalist, like the one in the United States, also being largely market-oriented. We have also seen the most prominent examples of socialism, notably the Soviet Union, also being command-oriented. This leads us to describe two extreme categories: **market capitalism** and **command socialism.**

But this simple dichotomization raises the possibility of "cross forms," namely, **market socialism** and **command capitalism.** Although less common than the previous two, both have existed.

The classic example of market socialism[7] was Yugoslavia. The state owned the capital stock (land was privately owned), but allocative decisions were made by worker-managed firms within a market framework. The collapse of Yugoslavia has raised questions regarding

5. For further discussion of this perspective, see Stephen Resnick and Richard Wolff, *Knowledge and Class* (Chicago: University of Chicago Press, 1989). These ideas have been further developed by the postmodernist school of Marxism whose ideas often appear in the journal *Rethinking Marxism*.

6. John R. Commons, *The Legal Foundations of Capitalism* (Madison: University of Wisconsin Press, 1931). This approach is sometimes labeled *old institutional economics,* with the *new institutional economics* emphasizing how institutions evolve to minimize transactions costs, a central process in economic history. This approach was initiated by Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (1937): 386–405, with Douglass North and Oliver Williamson being important in its development.

7. Variations on this term include *socialist market economy,* used by the Chinese to describe their system of market socialism, and *social market economy,* used by the Germans to describe their essentially market capitalist economy marked by extensive income redistribution and welfare programs.

the long-term viability of this particular hybrid. China has done well with its peculiar form of market socialism, although it appears to be gradually evolving into a peculiar form of market capitalism.

Yugoslavia's collapse and the rush toward market capitalism by most of Eastern Europe can be argued to confirm the argument of the Austrian economist Ludwig von Mises[8] that rational market calculation is possible only with capitalism because of the need for the profit motive to drive private property-owning decision makers to optimize and generate efficient price signals. (However, Yugoslavia's collapse may have been caused principally by regional and religious conflicts rather than economic failure.)

The classic example of command capitalism was Nazi Germany. Although the proper name of the Nazi Party was the National Socialist German Workers' Party, Adolf Hitler avoided nationalizing such privately owned corporations as Krupp and I. G. Farben. Nevertheless, these industries produced what his economic planners recommended. Similar systems appear temporarily in wartime in market capitalist economies, as in the United States during World War II, when no private cars were produced in response to government orders (although the automobile industry remained privately owned). A more recent example of command capitalism may have been the South Korean economy during the 1970s.

An important point to understand is that there are no pure examples of any type of system. *All* real economies are mixed economies exhibiting elements of various allocation and ownership systems, even if they can be categorized one way or the other.

Role of Planning

Many comparative economists emphasize the contrast of "market versus plan" as a central defining characteristic of economic systems rather than our choice of "tradition versus market versus command." Planning deals with coordination in an economy. In a centrally planned economy, **planners' preferences** dominate allocative decision making, whereas in a market economy **consumers' sovereignty** dominates allocative decision making.

There is a strong correlation between allocation decisions following a central plan and the general presence of command socialism, as in the Soviet Union and most of its empire. But this correlation misses the crucial point: that planners' preferences determine allocative decision making only within a command framework. It is command that rules out consumers' sovereignty.

It is possible to have command without planning. An example is Soviet Russia during the period of **War Communism** (1917–1921) immediately after the **Bolshevik Revolution,** when civil war was compounded by invasion by foreign troops. Production followed

8. Ludwig von Mises, "Economic Calculation in Socialism," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994, pp. 273–279), originally published in German in 1922.

commands from the center, but in a "shock" pattern whereby commands for production of certain goods were given when goods viewed as critical to the war effort became scarce. A pattern resulted of dashing higgledy-piggledy from producing one "deficit" good to another, with little effort to consider the impact of each decision or to coordinate such decisions. There was no time to plan or to even set up a planning mechanism.[9]

It is possible to have central planning coincide with market capitalism, the **planned market economy.** Such planning is known as **indicative planning** because it lacks the command element. Examples of indicative planning have been France and Japan, although such planning is less influential than in the past.

Even in thoroughly market capitalist economies there is planning by specific government agencies involved in infrastructure investment such as transportation networks, functions that in most economies seem to be in the public sector. For such cases, even the very pro-market capitalist magazine *The Economist*[10] argued in a lead editorial that there is a strong case for planning if it is carried out intelligently and is accompanied by the use of market mechanisms such as congestion tolls on highways to ensure efficient use of the resulting infrastructure.

It should also be noted that although ideologists of market capitalism generally eschew planning, most large corporations engage in long-range planning. This formed an important part of the argument by John Kenneth Galbraith in the 1960s that the American and Soviet economic systems were converging on partly planned, partly marketized *new industrial states*.[11]

Types of Incentives

Economies vary according to the incentive schemes that motivate people to work and produce. The most common incentive scheme is material, paying people according to their productivity. In market capitalism this involves paying them their marginal product that maximizes profits for competitive firms hiring labor in such a system.

Material incentives under market capitalism also take the form of rewards for entrepreneurship and capital investment as economic profits and for savings as interest. In theory, socialism rejects receiving profits; also in theory, Islam rejects receiving interest payments. Both socialism and Islam generally see material incentives as significant in motivating

9. The process of "planning how to plan" was labeled **planification** by Russian and French planners and economists, referring especially to the problem of coordinating micro-level plans at the macro level. Despite the low quality of the planning involved, it has been argued that, at least ideologically, the War Communism period saw the most serious attempt to achieve a true communist economy (Peter J. Boettke, *Calculation and Coordination: Essays on Socialism and Transitional Political Economy* [London: Routledge, 2001], chaps. 6, 7).

10. "The Case for Central Planning," *The Economist,* September 12, 1992.

11. John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1965).

labor.[12] But sometimes this motivation may be tied to pleasing some ideological or religious prescription or satisfying an elite, as in the system of perks given to top leaders in the former command socialist states.

An alternative that has sometimes been advocated and less frequently tried is **moral incentives,** trying to motivate workers by appealing to some higher collective goal. Efforts to implement moral incentives occurred in China under Mao Zedong during the **Great Proletarian Cultural Revolution** from 1966 to 1976 and during certain periods in Cuba under Castro. The Chinese effort followed the slogan "Serve the people." In both China and Cuba, these periods were characterized by serious economic stagnation.

But before dismissing moral incentives, note that they have been used temporarily when market capitalist economies have gone into a command mode during wartime. Thus production surged in the United States during World War II, despite the imposition of wage and price controls limiting the material gains from hard work. Part of the motivation to work came from the wartime appeal to patriotic national sacrifice.

The new traditional economy depends partly on appealing to moral incentives. Islam and most great world religions do not completely deny the pay-for-work principle that undergirds material incentives. But these belief systems also see limits to this principle, both from the need to provide charity for the poor and from the general argument that excessive concentration on acquiring material goods distracts from spiritual matters. Arguably in the extreme case of Afghanistan under Taliban rule, moral incentives became especially important, with the idea of martyrdom driving many actions.

Income Redistribution and Social Safety Nets

Economies vary based on the extent to which and the methods by which governments intervene to redistribute income. This depends partly on how unequal income is to begin with before any redistributive policies are implemented. Thus the Japanese government does much less redistributing than the governments of many other capitalist countries because Japan has a more equal distribution of wages than most other capitalist countries. Command socialist economies also have had less income redistribution because governments initially control the distribution of income by setting wages and forbidding capital or land income.

People differ greatly about the appropriate goal of income redistribution, much less the method. Ludwig von Mises and many in the **Austrian School of economics** argued that a just income distribution reflects a free market outcome in a context of well-defined property rights and complete equality of opportunity for all individuals, although his follower, Friedrich A. Hayek, occasionally argued that government should act to prevent individuals

12. That socialism has not always successfully implemented material incentives for workers is shown by the old Soviet joke that "they pretend to pay us and we pretend to work."

from falling below some minimum standard of living. The von Mises view suggests an ideal economy in which there is no government income redistribution.

Sharply contrasting with the preceding idea is John Rawls's[13] view that the justness of a society is to be judged by how well off its poorest individual is, the **maximin criterion.** He argues that selfish and rational individuals would support such a criterion if they fully understood the uncertainty of the future and realized that there is always the possibility that "there but for the grace of God go I." This suggests substantial redistribution toward absolute equality, limited only by disincentive effects becoming so great that the poorest individual's income drops.

Rawls's view echoes that of many traditional religions. None insist on absolute equality of income, but most place an emphasis on charity and taking care of the poor. Although organized religions may court the wealthy for their possible financial support, there is a vein of contempt toward wealth as exemplified by the remark of Jesus that "It is easier for a camel to pass through the eye of a needle than it is for a rich man to enter heaven."

In his 1871 *Critique of the Gotha Program,* Karl Marx enunciated the ideal goal of **pure communism** as being "from each according to his ability, to each according to his need." This does not imply complete equality of income, as people have different needs, for example, different family sizes or health problems. Marx contrasted this goal with that of socialism, which would be "from each according to his ability, to each according to his work."

Clouding this entire discussion is the **equity-efficiency trade-off,**[14] which states that greater efforts to make income more equal will result in less efficiency, meaning less rapid economic growth. The argument is that material incentives are what draw forth productive and entrepreneurial effort. Thus vigorous efforts to redistribute income reduce the rewards for work and entrepreneurship and thus reduce the rate of economic growth. Such arguments have become influential in many countries to scale back redistributive programs. This view had its most vigorous advocates among *supply-side* economists associated with the "Reagan revolution" in the United States and advising Margaret Thatcher in Great Britain.

Most societies struggle with intermediate approaches of one sort or another, although very poor countries generally cannot afford to do much redistributing, as there is not much to redistribute. Most carry out some redistribution through their tax codes and through some sort of **social safety net** for certain categories of people: the aged, the unemployed, single mothers with children, the sick, and sometimes others as well. In advanced capitalist countries, aging populations and medical care costs rising faster than the rate of inflation

13. John Rawls, *A Theory of Justice* (Oxford: Clarendon Press, 1972).

14. Arthur Okun, "Rewards in a Market Economy," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 71–77.

are putting tremendous fiscal pressure on social safety nets. Countries that have largely market capitalist economies but have very large amounts of income redistribution with large social safety nets are said to have **social market economies.** Germany and many of the Scandinavian economies are the leading examples of this system.

Generally in the command socialist economies a wider array of activities and people have been protected by social safety nets, although sometimes the quality of that protection has been questionable, as in the case of Soviet medical care. A major problem of the current transition period, with substantial economic declines in the FSU, has been the partial dismantling and weakening of these social safety nets without adequate replacements.

A final point regarding the equity-efficiency trade-off is that it is frequently false. Some of the most rapidly growing economies in the world have reasonably equal distributions of income, such as the East Asian **newly industrializing countries** (NICs), whereas some of the countries with very unequal income distributions have had poor growth records, such as many in Latin America. It is crucial that income and wealth inequalities arise from differences in productivity and entrepreneurship rather than from corruption or inheritance. If inequality is perceived as unfair, then the result may well be strikes, guerrilla war, or revolution, none of which are conducive to economic growth.[15]

Role of Politics and Ideology

The relationship between politics and economics is subject to deep debate. Until nearly 100 years ago no distinction was made between the two disciplines, there being only political economy. Many still think that is the way the subjects should be analyzed, and believe that they cannot be realistically separated. At the heart of the linkage is ideology, in which certain political and economic systems are linked in distinct packages and given labels such as *communism* and *liberal democracy.*[16] A central controversy has been whether or not political democracy is indissolubly linked with market capitalism and command socialism with dictatorship. Friedrich Hayek forcefully argues this position in his 1944

15. This problem plagues the former Soviet bloc economies in their transition efforts in that many new entrepreneurs are either former Communist Party officials with special privileges or former black marketeers whose sources of initial finance are viewed as illegitimate by most people. Indeed, there appears to be a link between corruption and inequality in these economies (J. Barkley Rosser, Jr., and Marina V. Rosser, "Another Failure of the Washington Consensus: Inequality and Underground Economies in the Transition Countries," *Challenge* 44 [March-April 2001]: 39–51). For further discussion of the argument that equality and growth may be positively related, see Torsten Persson and Guido Tabellini, *Political Economics: Explaining Economic Policy* (Cambridge, Mass.: MIT Press, 2000, chap. 14). They note that too much inequality can lead to excessive redistributive programs that damage incentives.

16. This use of *liberal* is the classical or European usage, meaning individual freedom and minimal government. The modern American usage, meaning support for government intervention in the economy, arose in the twentieth century from the evolution of the British Liberal Party toward such a position from its earlier classical position.

The Road to Serfdom, in which he claims that welfare state redistribution can lead to command socialist dictatorship. Milton Friedman supports this view in his *Capitalism and Freedom*. Friedman argues that even if expanded government activity does not lead to full-blown dictatorship, it constitutes a reduction in the freedom of the individual to choose what to do with his or her income because of higher taxes. Such views are labeled *libertarian* and have deep roots in American and British thought. The view that there should be minimal government economic intervention is called **laissez-faire,** a French term from the mid-1700s literally meaning "let them do it," them being businesspeople.

Both Hayek and Friedman associate socialism with dictatorship and lack of individual freedom. Complete socialism reduces economic freedom insofar as private ownership of capital and land is forbidden. The FSU was characterized by both economic socialism and political dictatorship. These countries are now generally moving toward both market capitalism and democracy.

But in Western Europe, social democratic political parties exist that call themselves socialist[17] but support neither extensive nationalization of the means of production nor political dictatorship. They support income redistribution and extensive social safety nets, although even in their heartland in northwestern Europe such approaches are under retreat. Nevertheless we have seen over 70 years of such **social democracy** in Sweden without the Hayekian prediction of political dictatorship coming true.

The split in Europe between socialist and communist political movements occurred after the 1917 Bolshevik Revolution in Russia, when Vladimir Lenin imposed a **dictatorship of the proletariat** under the leadership of a *vanguard party,* later combined with a command socialist economy by Joseph Stalin. Although many Western European socialist parties continued to support nationalization and central planning for a long time, they opposed dictatorship.

Ironically, the ideological father of communism, Karl Marx, claimed that communism entailed the withering away of the state. The dictatorship of the proletariat was to be a strictly temporary phenomenon. Well aware of this, the Soviet Communists never claimed to have achieved communism, always labeling their own system *socialist* rather than *communist* and viewing their system as in transition to communism.

The key libertarian claim that full-blown economic socialism has never coexisted with political democracy is true. But in some Western European countries, democratic governments have carried out substantial nationalizations without becoming dictatorships, such as Great Britain and Austria (even though both of these countries have more recently undone

17. Some of the former Communist parties of Eastern Europe have taken variations of this name. Thus in Germany there is the old Social Democratic Party, while the former Communists are now the Party of Democratic Socialism.

many of those nationalizations). Although absolutely forbidding private enterprise is incompatible with political democracy and personal freedom, having a great portion of the economy nationalized is not.

A further complication is that market capitalism has coexisted with authoritarian political regimes in parts of East Asia and Latin America. Many of these countries have recently experienced a trend toward democracy. Nevertheless market capitalism is no guarantee of political democracy even if the two are historically correlated. Indeed, the economy that is arguably currently the most market capitalist, Hong Kong, is not a fully functioning democracy, while another of the most market capitalist economies, Singapore, is quite authoritarian while formally democratic.

Another competing ideology is new traditionalism, especially Islamic fundamentalism. The focus in Islamic fundamentalism is not on either politics or economics as an end, but rather on religion and its rules. The basic demand of the Islamic fundamentalists is the imposition of an Islamic law code, a **Shari'a.**[18]

These codes address many issues, ranging from social matters such as restrictions on women's behavior to economic matters such as forbidding the charging of interest. But there is no definitive position on capitalism versus socialism. Nor is there a political theory of Islam other than the basic demand that a *Shari'a* be implemented and obeyed. It does not matter whether the enforcer of the law is a king, a mullah, a military dictator, or a democratically elected president. Indeed, the current Islamic Republic of Iran is a functioning, if limited, parliamentary democracy. But it is not a liberal democracy because individual rights and freedoms are subordinated to a *Shari'a* and the will of religious authorities.

Thus every generalization seems subject to exceptions rendering it almost unusable. But although liberal democracies have adopted the command mode of allocative decision making on a temporary basis during wartime, none has done so on a permanent basis during peacetime. Here is a more definitive hypothesis: Permanent command control of an economy implies unequivocal loss of personal freedom because none can be allowed to challenge the system of such control. Thus it is permanent command that is incompatible with liberal democracy, not economic socialism.

CRITERIA FOR EVALUATING ECONOMIES

Morris Bornstein[19] presents nine criteria by which the relative performance of economic systems can be compared.

18. There is more than one such code. See chapter 4 of this book.

19. "The Comparison of Economic Systems: An Integration," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 3–19.

First is the level of output. This figure should be corrected for population and the price level, giving us real per capita output as the measure that equals **real per capita income.** Despite difficulties in making cross-country comparisons because of differences in data gathering, this is probably the best measure of the material standard of living in a society available to us. The highest levels of real per capita income exist in market capitalist economies.

Second is the growth rate of output. This figure must be corrected for population growth. It is often easier for middle- to low-income countries to grow faster than either the very poorest or the very richest. The very poorest often are caught in **Malthusian low-level equilibrium traps** where little investment can occur because nearly all output is absorbed by consumption in an effort merely to stay alive. The middle- to low-income countries that have escaped from such traps can borrow technology from the most advanced countries and play catch-up according to the **relative backwardness hypothesis.**[20] Such borrowing can bring dramatic productivity improvements in an economy that is more backward than the world's leading economies. The growth of the richest countries is limited by the general advance of technology at the frontier of knowledge. Command socialist economies have sometimes grown quite rapidly for extended periods of time, but they suffer from a tendency toward serious stagnation in the longer run. More recently, evidence suggests links between measures of economic freedom in general and economic growth.[21]

Third is the composition of output. The most notable variables of composition are the breakdown between consumption and investment, the share of military output, and public versus private goods. Command socialist economies generally have higher shares going to investment, although the East Asian market economies, such as Japan, also have high rates of investment.

Fourth is **static efficiency.** Formally this means **Pareto optimality,** the idea that no one in society can be made better off without making someone else worse off. In this situation, resources are being fully utilized to their best potential given the existing technology, and as much is being produced as can be produced. Static efficiency implies that the labor force is fully employed and that the composition of goods being produced is what people want. It is widely argued that market economies are more successful in this area, although relative success is rather difficult to measure, and market economies tend to have worse unemployment than command economies.

20. "Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge Mass.: Harvard University Press, 1962).

21. See James D. Gwartney, Robert A. Lawson, and Randall Holcombe, "Economic Freedom and the Environment for Economic Growth," *Journal of Insitutional and Theoretical Economics* 155 (1999): 643–663. For a recent overview of characteristics separating successfully developed economies from those caught in deep poverty, see David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Some Are So Poor* (New York: W. W. Norton, 1999).

Fifth is intertemporal or **dynamic efficiency,** which involves the allocation of resources over time to maximize long-run sustainable growth. An example of nonsustainable output maximization was the effort by the Soviet Union to pump large amounts of oil in short periods of time. This push led to depletion of pressure in the wells, making it difficult or impossible to get out later the remaining oil that could have been accessible. Long-run sustainability of growth ultimately depends on maintaining a viable environment, and it is now seen that failure to do so was an important factor in bringing about the fall of the Soviet bloc command socialisms. Indeed, the few remaining command socialist economies, such as North Korea, are having severe problems maintaining positive economic growth.

Sixth is **macroeconomic stability,** the lack of large oscillations of output, employment, or the overall price level. It is usually argued that strict command economies achieve greater short-run macroeconomic stability, although there have been some spectacular exceptions. Indeed, the few remaining command socialist economies, such as North Korea, have tended to exhibit extreme macroeconomic instability since the breakup of the Soviet Union.

Seventh is economic security of the individual in terms of income, employment, and related matters such as health care. This criterion is partially related to the previous one, but it also depends on the broader social safety nets of an economy.

Eighth is the degree of equity of the income and wealth distributions. Generally the socialist and social market economies have more equal distributions than the strictly market capitalist economies.

Ninth is the degree of freedom available to the individual in terms of work, consumption, property, investment, and more broadly in the civil and political realms. This last variable is difficult to quantify, but market economies are well ahead of command economies in this area.

Many of the criteria listed above are difficult to quantify. Nevertheless, a summary of indexes of some of these criteria is presented in the tables below. Table 1-1 focuses on overall indicators, including per capita gross domestic product (GDP), an index of real per capita GDP, average rate of inflation, share of gross private investment in GDP, the quintile ratio (ratio of national income going to the top fifth of the population to that going to the bottom fifth), life expectancy at birth, and the United Nations **Human Development Index** (**HDI**), which is constructed from real per capita income, life expectancy, adult literacy rates, and measures of educational enrollment. This index can vary from 0.0 (bad) to 1.0 (good). The highest-scoring country for 2000 was Norway at .942 and the lowest was Sierra Leone at .275.

Table 1-2 focuses on the role of government, including the shares of GNP going to central government consumption, central government taxes, defense spending, spending on education, and spending on health. It also reports values for an **Economic Freedom Index** (**EFI**) that is constructed by the Heritage Foundation and the *Wall Street Journal*. It is based

Table 1-1
General Condition/Performance of Various Economies

Country	Real GDP (per Capita)	Growth Rate	Inflation Rate	Investment Share	Quintile Ratio	Life Expectancy	Human Development
Market Capitalist							
United States	34,142	2.2	2.7	21.0	9.0	77.0	0.939
Ireland	29,866	6.5	2.3	23.0	6.4	76.6	0.925
Hong Kong	25,153	1.9	5.8	28.0	n.a.	79.5	0.888
New Zealand	20,070	1.8	1.8	21.0	17.4	77.6	0.917
Colombia	6,248	1.1	20.6	12.0	20.3	71.2	0.772
Ivory Coast	1,630	0.4	7.2	10.0	6.2	47.8	0.428
Planned Market Capitalist							
Japan	26,755	1.1	0.7	26.0	3.4	81.0	0.933
France	24,223	1.3	1.6	21.0	5.6	78.6	0.928
S. Korea	17,380	4.7	5.1	27.0	5.3	74.9	0.882
India	2,358	4.1	9.1	24.0	5.7	63.3	0.577
Social Market Capitalist							
Germany	25,103	1.2	2.2	23.0	4.7	77.7	0.925
Sweden	24,277	1.6	1.9	18.0	3.6	79.7	0.941
Costa Rica	8,650	3.0	15.6	18.0	11.5	76.4	0.820
Sri Lanka	3,530	3.9	9.9	26.0	5.3	72.1	0.741
Market Socialist							
China	3,976	9.2	8.6	39.0	8.0	70.5	0.726
Egypt	3,635	2.5	8.8	23.0	4.0	67.3	0.642
Former Market Socialist							
Slovenia	17,367	2.8	24.6	28.0	4.1	75.5	0.879
Hungary	12,416	1.9	20.3	31.0	3.5	71.3	0.835
Command Socialist							
Cuba	3,967	6.2	−0.1	n.a.	3.3	76.0	0.795
Laos	1,575	3.9	28.2	24.9	6.0	53.5	0.485
Former Command Socialist							
Czech Republic	13,991	1.0	7.8	30.0	3.5	74.9	0.849
Russia	8,377	−4.6	99.1	22.0	12.2	66.1	0.781
Ethiopia	668	2.4	5.3	17.0	6.7	43.9	0.327
New Traditional							
Iran	5,884	1.9	26.0	20.0	n.a.	68.9	0.721
Pakistan	1,928	1.2	9.7	15.0	4.3	60.0	0.494

Source: Real per capita gross domestic products (GDPs) are for 2000 in U.S. dollars, adjusted for purchasing power parity (PPP) from the *Human Development Report 2002* (New York: Oxford University Press for the United Nations Development Program, 2002), pp. 149–152. Growth rates are annual average rates of per capita GDP for 1990–2000 from the *Human Development Report 2002,* pp. 190–193, except for Cuba, which is for 2000–2001 from Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C., and New York: Heritage Foundation and Wall Street Journal, 2002), p. 167, and *Human Development Report 2000,* p. 224. Inflation rates are annual average increases in consumer price indexes (CPIs) for 1990–2000 from *Human Development Report 2002,* pp. 190–193, except for New Zealand, which is from *Human Development Report 2001,* p. 169, and Cuba, which is from *2002 Index of Economic Freedom,* p. 168. Investment share is gross domestic investment as a percentage of GDP for 2001 from *World Development Report 2003* (New York: Oxford University Press for the World Bank), pp. 238–239, except for Laos, which is for 1998 from *Human Development Report 2000,* pp. 206–209. Quintile ratios are for the most recent year between 1991 and 1999 from *Human Development Report 2002,* pp. 194–197, except for Cuba, which is for 1978 from Claes Brundenius, *Revolutionary Cuba: The Challenge of Economic Growth and Equity* (Boulder, Colo.: Westview Press, 1984), p. 15. Life expectancy is in years at birth for 1995–2000 from *Human Development Report 2002,* pp. 174–177. Human development index (HDI) is from *Human Development Report 2002,* pp. 149–152, and is for 2000. The index is constructed from real per capita income based on PPP, life expectancy at birth, adult literacy rates, and educational enrollment measures, and it can vary from 0.0 to 1.0. Countries with an HDI above .80 are considered to have "high human development," those with an HDI between .50 and .80 are considered to have "medium human development," and those with an HDI below .50 are considered to have "low human development."

Table 1-2
Role of Government in Various Economies

Country	Government Expenditure	Taxes Spending	Military Spending	Education Spending	Health	Economic Freedom
Market Capitalist						
United States	21.1	20.5	3.1	5.4	5.7	1.80
Ireland	35.5	31.6	0.7	6.0	5.2	1.80
Hong Kong	15.1	15.0	n.a.	2.9	2.1	1.30
New Zealand	33.4	32.1	1.0	7.3	6.3	1.70
Colombia	16.0	10.1	2.3	4.4	5.2	2.85
Ivory Coast	24.0	20.8	0.9	5.0	1.2	2.90
Planned Market Capitalist						
Japan	13.7	13.7	1.0	3.6	5.7	2.45
France	46.6	39.2	2.6	6.0	7.3	2.70
S. Korea	17.4	17.3	2.8	3.7	2.4	2.50
India	14.4	8.6	2.4	3.2	0.6	3.55
Social Market Capitalist						
Germany	32.9	26.5	1.5	4.8	7.9	2.10
Sweden	42.7	35.8	2.1	8.3	6.6	2.05
Costa Rica	30.1	23.1	0.0	5.4	5.2	2.65
Sri Lanka	25.0	14.5	4.5	3.4	1.7	2.80
Market Socialist						
China	8.1	5.7	2.1	2.3	2.1	3.55
Egypt	30.6	16.6	2.3	4.8	1.8	3.55
Former Market Socialist						
Slovenia	42.0	35.0	1.2	5.7	6.7	3.10
Hungary	43.4	31.4	1.5	4.6	5.2	2.40
Command Socialist						
Cuba	n.a.	n.a.	n.a.	6.7	8.2	4.75
Laos	24.8	n.a.	2.4	2.1	1.2	4.55
Former Command Socialist						
Czech Republic	35.0	31.6	2.0	5.1	6.6	2.40
Russia	25.4	18.4	4.0	3.5	4.5	3.70
Ethiopia	24.6	12.2	9.4	4.0	1.2	3.55
New Traditional						
Iran	26.7	11.2	3.8	4.0	1.7	4.55
Pakistan	21.4	12.6	4.5	2.7	0.7	3.30

Source: Government expenditures and taxes spending are percentages of GDP of central government expenditures and central government taxes for 1998 from *Human Development Report 2000,* pp. 205–209, except for Hong Kong, Slovenia, and Laos, which are for 2000 from *2001 Index of Economic Freedom,* pp. 198, 331, and 237, respectively, and Japan and Ethiopia, which are for 1990 from *World Development Report: Attacking Poverty 2000-2001,* pp. 300–301. Military spending, education spending, and health spending are amounts spent by central governments as percentages of GDP for 1998, 1995–1997, and 1996–1998, respectively, from *Human Development Report 2000,* pp. 214–217. Economic freedom is an index ranging from 1.0 (fully free) to 5.0 (fully unfree) for 2002 from *2002 Index of Economic Freedom,* pp. 22–28. Index ranges of 1.00–1.95 are labeled as "free," 2.00–2.95 as "mostly free," 3.00–3.95 as "mostly unfree," and 4.00–5.00 as "repressed." This index is an average of numbers using the same scale and weighted equally for the following nine categories: trade policy, fiscal burden of government, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and black market activity.

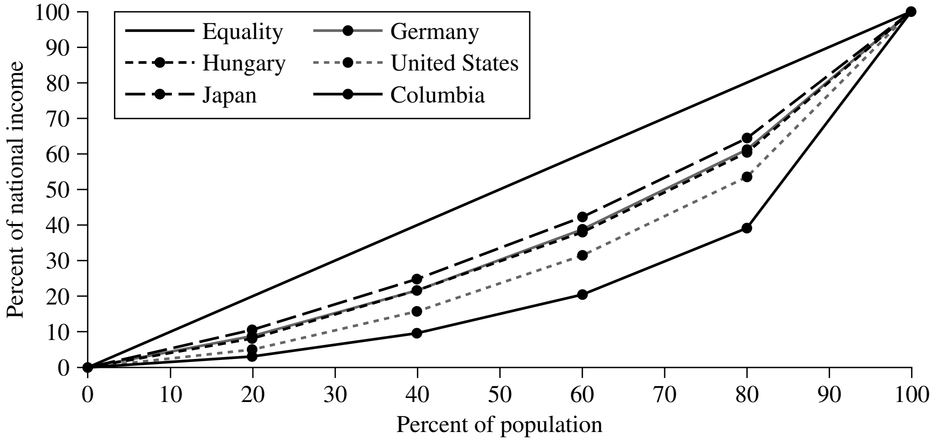

Figure 1-1
Lorenz curves.
Source: World Development Report 2000–2001 (World Bank), Table 5.

on 10 subindexes and can vary from 1.0 (economically free) to 5.0 (economically unfree). For 2002, Hong Kong was the freest at 1.3, while North Korea and Iraq were the least free, both at 5.0.

Data for many countries are unreliable, especially for many less developed countries that do not have money for gathering data. For former and current socialist countries, data unreliability arose from past propagandistic lying and corruption, as well as the bureaucratic tendency toward secrecy. Even officials in these countries could not get accurate data.[22] Unsurprisingly, there were massive revisions of data in some of these countries during the 1990s.

Figure 1-1 shows income distribution in several countries using **Lorenz curves.** These rank a country's population on the horizontal axis according to income, with the vertical axis showing the percentage of national income going to that group of the population. As the curve moves away from the diagonal 45-degree line, income becomes more unequally distributed. The rankings provided by Lorenz curves correlate strongly with the rankings provided by the quintile ratios.

The Lorenz curve can be used to generate another measure of income distribution used later in this book, the **Gini coefficient.** This is the area between the Lorenz curve and the

22. Many top think tanks of the USSR used data on their own economy estimated by the U.S. Central Intelligence Agency (CIA) in the belief that it was the best available. Ironically, after the collapse of the USSR, there was criticism in the U.S. Congress of the CIA for the alleged inaccuracy of those estimates.

45-degree line divided by the total area under the 45-degree line. Thus, Gini coefficients range from 0 to 1, with higher values indicating greater inequality.

The numbers presented in tables 1-1 and 1-2 are broadly consistent with the generalizations made earlier despite various anomalies and odd cases. Some of these may be the result of data imperfections, but certainly not all of them. A close examination of these numbers should emphasize the uniqueness of each economy and the difficulty of attempting to classify economies into neatly defined categories. There is ultimately a degree of arbitrariness to such a procedure.

SUMMARY AND CONCLUSIONS

Fukuyama argues that the world economy is converging on American-style market capitalism. But this is a very complex process in a troubled and transforming world economy. In comparing economies, central issues are the allocation system—traditional, market, or command—and the ownership system—capitalist or socialist. Economies vary in their income redistribution approaches, as well as in their political systems and ideologies. Bornstein presents nine criteria for evaluating the outcomes of economies, and we provide data related to these criteria for 25 countries, both for general performance indicators and for the role of government in their economies.

Although many of the data are consistent with our expectations for the economic systems identified for the respective countries, numerous anomalies exist. Thus, there are many other elements besides those listed in this chapter that are important to the functioning of an economy and its essential nature. A short list includes its openness to international trade and investment; its industrial organization; its policies with respect to the environment; the sectoral breakdown of its industries; its degrees of literacy and urbanization; its population density; its labor-management relations; its macroeconomic policies; the nature of its legal system; its level of corruption; its level of generalized trust, or **social capital;** and the broader cultural attitudes of its people, among others. Many of these will be discussed later in the individual country studies.

QUESTIONS FOR DISCUSSION

1. Why does Fukuyama think that we are at “the end of history” and how is his idea relevant to comparative economics?
2. Are market economies necessarily capitalist and are command economies necessarily socialist? Why or why not?

3. Even though the U.S. economy is probably the most modern and market capitalist–oriented economy in the world, it contains elements of a traditional economy. What are some examples?

4. Is market capitalism necessary for freedom? Why or why not?

5. Distinguish between the Rawlsian, socialist, and pure communist views of how income should be distributed.

6. Considering tables 1-1 and 1-2, what are some countries that exhibit characteristics or performances not in accord with the generalizations made in this chapter with regard to the systemic category into which they are placed? What are those characteristics or performances and how are they anomalous?

7. Based on table 1-1, what are some examples of countries that have a somewhat higher HDI while having somewhat lower real per capita GDPs? How can this happen, and can you see evidence of this in the table?

8. Based on table 1-2, do you see any patterns regarding the relationship between the EFI and the category of economic system? Does this make sense? Is there any pattern of relationship between the EFI and the HDI? Does this make sense?

9. How have developments in the world since September 11, 2001, affected the way we analyze economic systems and their relationships with each other?

SUGGESTED FURTHER READINGS

Bornstein, Morris. "The Comparison of Economic Systems: An Integration," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. Burr Ridge, Ill.: Irwin, 1994, pp. 3–19.

Boyer, Robert. *The Regulation School: A Critical Introduction*. New York: Columbia University Press, 1990.

Dasgupta, Partha, and Ismail Serageldin, eds. *Social Capital: A Multifaceted Perspective.* Washington, D.C.: World Bank, 2000.

Friedman, Milton. *Capitalism and Freedom*. Chicago: University of Chicago Press, 1962.

Fukuyama, Francis. *The End of History and the Last Man*. New York: Free Press, 1992.

Hayek, Friedrich A. *New Studies in Philosophy, Politics, Economics, and the History of Ideas.* Chicago: University of Chicago Press, 1978.

Neuberger, Egon. "Comparing Economic Systems," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. Burr Ridge, Ill.: Irwin, 1994, pp. 20–42.

Okun, Arthur M. "Rewards in a Market Economy," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. Burr Ridge, Ill.: Irwin, 1994, pp. 71–77.

Persson, Torsten, and Guido Tabellini. *Political Economics: Explaining Economic Policy.* Cambridge, Mass.: MIT Press, 2000.

Polanyi, Karl. *The Great Transformation*. Boston: Beacon Press, 1944.

Rawls, John. *A Theory of Justice*. Oxford: Clarendon Press, 1972.

Resnick, Stephen, and Richard Wolff. *Knowledge and Class*. Chicago: University of Chicago Press, 1989.

Sciabarra, Chris Matthew. *Marx, Hayek, and Utopia*. Albany: State University of New York Press, 1995.