

Professor's Insert: Assigned Topic for Paper 1

What are the theoretically appropriate roles of government in a market (capitalist) economy? Consider and explain the pros and cons of government intervention versus laissez faire. Next, contrast this discussion with the theoretical role of government in a socialist economy based on Marxist-Leninist principles. Be sure to consider the views expressed in Mancur Olson's Power and Prosperity on this topic. Finally, choose one of the countries in Part III of the Schedule of Readings and Lectures, and use it as an example to illustrate your theoretical discussion. This first paper should require only a little research beyond the lectures, assigned books, and suggested readings.

Theoretical and Hybrid Economic Systems

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EC 301: Comparative Economic Systems

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Abstract

While labels for classification of economic systems are convenient, they often ignore the individual characteristics of a nation's economy. Labels also confuse. The idea that purely socialist or capitalist economies exist outside a textbook is asinine. By labeling an economy one thing or another, the idea that economic systems are blends of theoretical ideals and mixing components of many systems to form one that fulfills the desires of the society operating in the economy becomes more and more dim.

Introduction

Members of every society must find a way to meet basic survival needs, such as water, food, and shelter. But when a society begins to grow and division of labor occurs, the social order is presented with three questions. First, what goods should the society produce, second, how should the society produce the goods, and third, for whom should these goods be produced? The presentation of answers is usually given through the economic structure developed by the society. Each economic system operates on theoretical ideals stipulating the system's structure. And while there are models and generalizations for classification of these economic systems, markets are a mixture of different economic systems that best fits the beliefs, goals, and objectives of a society, no matter how economically inefficient those desires may be. Economies are as unique and varied as the people that operate within them.

The Role of Government in a Capitalist Economic Structure

The capitalist economic structure, or the market structure, is based on Smith's (1998: 12-13) ideas that not only were people "led by an invisible hand" in a direction that would result in efficient markets, but that an efficient, self-equilibrating economy was an inevitable outcome. If markets are inherently efficient, government intervention is not necessary. But because there are certain goods that cannot be produced by private enterprise efficiently or in a large enough quantity, such as a legal system, national defense, or any essential component of an economic infrastructure, governments are crucial. Although Smith (1998: 380) agreed they are necessary, he believed governments are wasteful and hinder economic growth. Malthus, his successor, argued that there was a balance between productive (competitive markets) and non-productive (government) sectors of the economy that can foster economic growth. And according to Olson

(2000:13), there is another invisible hand that compels people in power (government) to use their power for the benefit of the society. This suggests that government actions are not always counterproductive in a society.

It seems the extent of the role of government in a capitalist society is always in question. Although economists disagree on a lot of things, they generally agree that in a pure market economy freedom of choice is of paramount importance and the role of government should be limited to providing for societies needs above and beyond the capabilities of private enterprise (Kennett, 2001: 21).

Government Intervention Versus *Laissez Faire*

Markets are not entirely infallible. Failures do occur, usually when any of the conditions for perfect competition aren't met. Failures occur when the economy either has incomplete markets, imperfect competition, or imperfect information. Government is established to improve the performance of the market economy by providing an infrastructure in which the economy can efficiently operate (Watts, 2000). To combat incomplete markets and imperfect competition, governments establish anti-trust laws and penalize organizations for producing negative externalities. Some public goods that cannot be provided by private enterprise, such as national defense, are taken on by the government to ensure that need is met. In the fight against imperfect information, governments often try to create transparency in markets. That is to say, the regulation of information disclosure is of paramount importance for the consumer or the investor, and disclosure requirements are often enforced by law, as with the Securities and Exchange Commission, or the Truth in Advertising Laws. For a stable market economy to exist, there must

exist a stable government with clearly defined property rights and laws as well as “democratic practices” (Sullivan, 2000).

While government intervention can solve some market failures, it is not a panacea. A government cannot always fix a market failure: governments fail too (Kennett, 2001:92). Some economists believe the market is self-correcting in the long run and should be left alone. This would suggest that when governments intervene to correct market failures, they may be creating far more problems for the economy than if they allowed the situation or “failure” to run its course. Because large bureaucracies are extremely difficult to manage, the public interest is impossible to determine accurately, politicians act in their self interests, governments are stuck with those like-we-could-ever-solve-that-in-a-million-years problems (such as the war on drugs or prohibition), and because the objectives of the state don’t always coincide with those of the individuals or the society, it is very easy for a government to fail in improving the efficiency of the market. When this happens, government falls short.

The dilemma that arises is this: a society can eliminate the chance of government failure by pursuing a *laissez faire* policy. But elimination of government in an economy opens that society up to the market failure risk where individuals may lack protection and enterprise doesn’t have the necessary backbone upon which they can develop a strong, dynamic economy.

The Role of Government in a Socialist Economic Structure

Socialism is the developmental link between capitalism and communism (Kennett, 2001: 57). One of the most interesting aspects of the study of economics are the economists themselves. While students are hard-pressed to find economists that agree, it seems all economists have a theory on economic stagnation or the demise of economic systems. To

communists, socialism is the phoenix that will rise from the ashes of capitalism after its inevitable demise. Just as feudalism begat capitalism, capitalism will lead to socialism which will culminate with communism.

Since socialism is another stepping stone toward communism, it is the responsibility of a socialist government to set up the communist infrastructure. The first step toward this goal is the eradication of private property (Marx and Engels, 1848/1998: 67). Centralizing the means of production in the hands of the government is the most important step in moving an economy from capitalism to socialism. Other required steps include centralized planning, a highly progressive income tax structure, abolition of inheritances, an extensive public education system, and centralized planning by the government (Marx, et. al 1998: 75).

The ultimate goal of communism would be realized when scarcity and private property are eliminated, government was unnecessary, and the people governed themselves unselfishly (Kennett, 2001: 57). If the goal of a socialist society is to create this outcome, a reduction in the size of government is required. But, historically, socialist leaders have done nothing to reduce their role and instead find newer, more creative ways to exploit the people over which they rule and increase power through the accumulation of wealth (Olson, 2000: 130).

Japan: A Hybrid Economic System

Purely capitalist and purely socialist economies exist only in theory. Existing economies are a fusion of elements from many theoretical economic systems that emerge in a synthesis economy structured to efficiently attain the economic goals of a society.

The initial industrialization of Japan was state-led and much of the industry in Japan is still state owned. For example, steel and shipbuilding industries are run through the public sector

(Kennett, 2001: 221). Government programs control the distribution of resources by offering protection to specific industries, eliminating the opportunity for the market to distribute resources efficiently (Japan Association of Corporate Executives, 1997). Government regulated industry accounted for over 40% of Japan's GDP in 1995. Actively intervening in the development of industry, Japan's government uses "industrial policy" determined by the Ministry of International Trade and Industry to take the place of market forces (Kennett, 2001: 240). The Ministry, or MITI, is an organization that determines which sectors of industry will be experiencing growth in the near future, and then uses the Bank of Japan, the country's central bank, to ensure funding to companies in the pre-determined growth sectors of the economy (Kennett, 2001: 237). Not only is funding regulated, there are also controls on entering the market, production volume, and prices (Japan Association of Corporate Executives, 1997).

Ownership of the means of production is the primary factor in distinguishing capitalism from communism (Kennett, 2001:17). Centralized planning is also a characteristic of a communist society (Kennett, 2001: 21). It appears as though, according to these standards, that the Japanese economy is on the fast track to socialism. Not true. The centrally planned nature of the economy is a holdover from the initial industrialization movements following the Meiji Restoration in 1853 and 1868. In order to rapidly transform a society that was still very much feudal in structure and dominated by Confucian morals – basically, a society based on the utmost respect for power and authority – into a viable worldwide trading entity, government organization of growth was necessary (Kennett, 2001: 221-225). Without centralization, regardless of how inflexible that method of organization may be, the growth of the economy would not have proceeded as efficiently and rapidly as it did. But now that the economy has achieved parity with and even surpassed some of the largest economies in the world, Japan is no

longer a follower. Now, instead of walking in the shadow of larger countries that have “been there, done that, got the t-shirt,” Japan is standing next to those other countries. Unless market entry and exit regulations are lifted, price and wage controls are eliminated, the size of the public sector is greatly reduced, and the market is allowed to operate, Japan’s economy will soon fall back into shadow (Japan Association of Corporate Executives, 1997).

Japanese markets may be centrally planned and publicly owned to a certain degree, but decentralized indicative planning and free markets are also present. About one half of the Japanese economy is truly a free-market area where innovation, efficiency, and competition are rampant, allowing the economy to operate in the dynamic global market (Japan Association of Corporate Executives, 1997). While economic planning is centralized, it is not coercive as it is in socialist societies. The indicative planning used in many capitalist countries is used to forecast the general direction of the economy, but participation is entirely voluntary (Kennett, 2001: 21).

Enterprise in Japan is moving more and more toward a market economy. Downsizing of public sector industry has seen the number of government corporations reduced from 111 in the early 1980s to 97 in the late 1980s (Federal Research Division, 1994). Efforts to increase transparency in industry, and subsequently improve information sharing have been growing in the past few years, especially since the recent banking fiascoes (Japan Association of Corporate Executives, 1997). Despite all these movements to make the Japanese economy more like the western economies, culture prevails. The Japan Association of Corporate Executives made a Policy Proposal entitled “Efficiency and Trust: Creating a Market-Oriented Economy in Japan.” After a full fourteen pages criticizing the ineffectiveness of the Japanese economic system and suggesting ways to change it, the Association concedes that it doesn’t want too free of a

marketplace. Basically, increased faith in market mechanisms is desired, but intervention is still desired to prevent market failure and promote equality.

Conclusion

Labeling an economic system may work for identifying a theory. To try and label an actual functioning economy is to try and cram a square peg into a round hole. Every society answers the three economic questions differently. For pure capitalists, the wants of individuals will be satisfied by someone else in society through a market that will change as the people in society change. The questions will be answered in a way that best satisfies the wants of those individuals. For a pure socialist, the state determines who needs what, and subsequently who will produce what and how. Economic systems have more to do with culture than economic charts and data. Regardless of the specific economic system, the questions are answered in a way that will reach a society's goals – goals based on the history and culture of a society.

The history and culture of Japanese society and its present goals have generated Japan's current economy. State ownership of firms, some centralized planning, and the structure of enterprises is all based on the history of the keiretsu system and modernization movements unique to Japan. The transparency of firms and increasing privatization are recent changes that have been instituted to meet the changing needs and desires of the Japanese people. But the social goals of stable markets and equality have tinted every economic movement in the country because while the economy changes, it changes in accordance with the goals and desires of the Japanese people.

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