Economic Systems

Jose Rivera works full time at Walmart and makes $10 an hour for a full-time wage of $400 per week.

Sarah Kazantis makes $60 an hour as a program manager.

Dr. Novara makes $175,000 a year as a primary care physician.

Mr. Foster is the Chief Executive Officer of a large corporation and makes $13.8 million per year.

Alice Walton, the heir to the Walmart Corporation, has a net worth of $33.9 billion, and does not work at all.

**Capitalism** is an economic system in most industries and businesses in a country are privately owned. Capitalists are people who use their own money, or other’s people’s money, to start or invest in businesses. They can make money without working at all.

You’re probably not surprised to hear that some people in a society are extremely wealthy, while others are very poor. Does it *have* to be this way? That’s a good question. In order to answer it, it’s helpful to learn a little more about how capitalism developed, and the theory about how it works. Then, it helps to look at two other economic systems: communism and socialism.

**A Brief History of Capitalism**

If you live in a capitalist system like the one we have in the United States, you may think that’s “just the way things are,” or that “things have always been this way.” The fact is, capitalism has not always been the economic system in most of the world.

In Europe during the 5th-11th centuries, most people lived by farming. Farming required land, so those who owned a lot of land—the lords, or noblemen--were the ones who were wealthy. Lords inherited their land, so land was usually kept in one family for generations. Those who did not own land (the peasants) usually worked on the lord’s land and had to give some of what they grew to the lord who owned the land, while keeping some for themselves.

In the 18th and 19th centuries, the Industrial Revolution changed human life radically. Before the Industrial Revolution, most people had made a living from farming, and machines were not a big part of people’s lives. That changed when a number of inventions, such as the steam engine, the power loom, and other machines, began to make it must easier and efficient to make things. Once these machines were invented, it was possible to build a factory where things like textiles could be made very efficiently. Now any man who could gather enough money, or capital, to buy a factory could become very rich. And now peasants who had to work on a lord’s land for a living had another way to make a living: they could work in a factory.

**Adam Smith**

In 1776 a Scotsman named Adam Smith wrote a book called *The Wealth of Nations* which explained his theory behind capitalism. Smith stated the theory of capitalism in this way: an economic system can work very well if people follow their selfish interests.

Here was Smith’s idea: People naturally want to make a living. Those who have something to sell, whether it is their own labor, or something they have made, like bread, want to get the highest price they can possibly get. Those who are buying, whether it is a loaf of bread, or the labor of a worker, want to get the best deal they possibly can—they want to pay the least amount of money possible for the best bread, or the best worker.

In trying to get the best bargain, whether they are selling or buying, people compete. Let’s say Baker Alfonso is selling bread at $1.00 a loaf, and people are buying. Then, Baker Hippolito opens a bakery down the street and starts selling bread for 90 cents. The new baker, Hippolito, will make probably get more business and make more money, and Baker Alfonso will probably lose business.

Now let’s say the Baker Alfonso decides to compete. He wants to lower his price to 85 cents a loaf. Maybe he finds a cheaper place to buy flour, or he works longer hours, or he pays his helpers less. Now people will buy Alfonso’s bread. However, if Alfonso starts using a lower grade of flour and his bread doesn’t taste as good as it used to, lowering the price will not help.

The idea is that through competition, buyers will end up with the best bread at the best price. Smarter, more competitive sellers will win most of the business. In this way, through self-interest, society as a whole will benefit. Smith wrote:

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.

According to Smith, economic self-interest-each person’s desire to meet their economic needs such as money for food, clothing, and shelter—is a force that powers all economic activity. Free competition between buyers and sellers brought prices to the “natural” or “equilibrium” price—the price people were willing to pay for a product, and that sellers were also willing to sell.

Smith called this “the invisible hand” of the market place. The government does not need to make a law about the price that a seller is allowed to charge, or the price that a buyer must pay. Through competition, the right price will be arrived at naturally.

**Laissez Faire**

Laissez faire is a French word which means “leave it alone.” Smith believed that this was the role the government of a country should play in an economy—it should leave the economy alone. The government, said Smith, should not interfere with business in any way. The “invisible hand” would cause markets to regulate themselves. Smith believed that government only had three legitimate functions in a free economy:

* Protect the country from foreign invasion
* Protect citizens from crimes done by their neighbors
* Build public works, or infrastructure, that would allow business to function. Examples of infrastructure include roads and railroads that allow goods to be transported; public utilities that allow for electricity to be produced that is used in factories and stores, etc.

**Advantages and Disadvantages of Capitalism**

Capitalism has been a successful economic system in many ways. If a person invents a product that is in high demand, like Microsoft Word, he or she can make a lot of money. A successful business employs many people, and those employees make salaries that they then spend in many different places—the supermarket, clothing stores, etc—so that the money flows through the economy and everyone benefits.

Capitalism also has some drawbacks. One drawback is the tendency toward monopolies. In the late 1800s, some capitalists in the U.S. built companies so huge and powerful that they did away with almost all competition. An example is Cornelius Vanderbilt, who built Grand Central Station in New York City. Vanderbilt grew richer and richer until he was able to buy all the railroad lines around New York. Once he had done this, he could eliminate competing businesses and set prices where he wanted them to be. (One powerful company acting alone is known as a monopoly. A group of such companies is called a trust. )

Monopolies became a huge problem in the late 1800s. The Sherman Antitrust Act (1890) outlawed monopolies in the United States. President Theodore Roosevelt (1901-1909) enforced the law so strongly that he became known as the Trust Buster.

Monopolies have developed in more recent times, too. AT&T, the telephone company, grew to become the largest conglomerate in the world until it was dismantled by the U.S. Department of Justice in 1984.

Another disadvantage of capitalism is exploitation of workers. One of the ways that a capitalist, or factory owner, can make a bigger profit, is to get as much work as possible out of employees, while paying the lowest wages. During the early 1900s in this country, factory owners in New York City would exploit workers in a variety of ways—for instance, by locking them into the factory until the work was finished. A famous incident that took place as a result of exploitation by factory owners was the Triangle Shirtwaist Factory Fire. Factory owners locked the workers in to make sure the work was finished. When fire broke out, workers were trapped inside the factory, and many died. The same type of tragedy takes place today in places like Bangladesh. Most manufacturing work has moved to countries where workers can be paid much lower wages. This means owners—of clothing companies, for instance—make a bigger profit.

**The Great Depression and Laissez Faire**

In the Great Depression of the 1930s, capitalism almost collapsed as a system. The stock market crashed in 1929, many businesses went bankrupt and the unemployment rate rose to 25%. Many people were evicted from their homes and could barely survive. This event called into question the success of capitalism, and the “laissez faire” approach that the government should stay out of the economy.

In order to pull the U.S. out of the Great Depression and help people who were down and out, President Franklin D. Roosevelt introduced a broad social welfare program to help the needy as part of his New Deal legislation. This was a whole new approach, in which the government became involved in the economy, and took on the role of providing an economic safety net for its citizens. Today, the federal social security and unemployment insurance programs give Americans protections they did not have before the 1930s. Government-funded welfare programs also provide aid for people in need.

Today, there is a lot of debate in this country about how involved government should be in the economy. Republicans and conservatives tend to believe that the government should not provide safety economic safety nets for citizens, and that government should not regulate business. Their argument is that all people have an equal opportunity to succeed at business if they are smart enough or work hard enough. Democrats and liberals tend to believe that government should be more involved in the economy. They believe that government needs to regulate business so that poor people are not overly exploited. They also think that government should provide a safety net for people who need it.

**Communism**

Comrade Bulgakov works at a factory that is owned by the state. His apartment is also owned by the state, and was assigned to him. He makes the same salary as every other worker in the factory.

Comrade Mogilat works as a schoolteacher. Her apartment is owned by the state and was assigned to her. She makes the same salary as every other worker in the school.

The theory behind communism is that mankind would live best in a classless society in which all property is owned by the community as a whole and where all people enjoy equal social and economic status. As a political movement, communism sought to overthrow capitalism through a workers’ revolution, and redistribute wealth in the hands of the working class**.**

**Early Communism**

Communist ideas have existed since ancient times. Primitive humans, living in tribes, worked for the benefit of their entire clan and shared the fruits of their labor. Throughout the ages, groups of people have tried to live communally, sharing all goods and all labor equally. But these were all very small attempts at creating a communist society. The first time the theory of communism was actually put into action on a large scale was in the Soviet Union, and it was based on the ideas of Karl Marx and Friedrich Engels.

**The Ideas of Marx and Engels**

Karl Marx and Friedrich Engels were philosophers who lived during the 19th century in Europe. During that time, big changes were taking place in the way people lived and worked. These changes were caused by the Industrial Revolution.

Prior to the Industrial Revolution, most people made their living by farming. People had a certain amount of land. They grew crops and raised animals to feed themselves. They traded among each other to get some of the goods they needed and could not produce by themselves. This changed with the Industrial Revolution.

The Industrial Revolution began in England in the 18th century. Machines began to be invented that could make certain kinds of work happen much faster and more efficiently. One area in which this took place was textiles. Through new machines that were invented, it suddenly became possible to make more clothing much more quickly and efficiently than ever before. At the same time, through its colonies, England suddenly had access to lots and lots of cotton from the American South. Merchants who were rich enough to buy factory machinery, build factories, buy cotton, and hire workers could become very rich.

The Industrial Revolution may have brought great riches to those who could afford to build and operate factories, but for the workers, life was often worse. In England at this time, many small farmers were kicked off of their land. This gave them no choice but to go to work in the factories. When they worked for a factory owner, however, workers had to accept whatever pay the factory owner paid them. The best way for factory owners to make a profit was to get as much work as possible from his workers and pay as little as possible. Karl Marx noticed that this was what was happening. In his view, factory owners, or capitalists, were able to get rich by exploiting their workers and keeping the profits for themselves. Marx thought the working class, or proletariat, should revolt against the ruling class, or bourgeoisie. He believed it was only a matter of time before working people realized that they were being exploited and banded together to fight the owners. Marx’s vision was that eventually the whole world would become a communist paradise run by workers. One of his slogans was “Workers of the world, unite!”

In Marx’s view, the best society was one in which no one owned property and there were no classes. Everyone was equal to everyone else, and all work was valued the same since it contributed to the whole group. He thought society should run according to this principle*: From each according to his ability, to each according to his need.*

Marx’s ideas were not tested or put into action on a large scale until the Russian Revolution of 1917.

**The Russian Revolution and the Red Terror**

Vladimir Lenin, the leader of the Bolshevik Party (later to be called the Communist Party), came to power in 1917 after the Russian Revolution. One of his first moves was to make laws to redistribute land -- taking it from the rich nobility and giving it to the poor. Lenin initiated the **Red Terror**, a threatening fear campaign aimed at destroying any monarchist and anti-Bolshevik sympathizers, which he accomplished through three main methods.

* **Man-made famine** was Lenin's most successful tool. He knew that if he could break the peasantry, he'd have full control. Lenin engineered famines by requiring peasants to sell their crops to him at virtually no profit. The peasantry was so indignant that they reduced crop production drastically. The exact numbers vary, but tens of millions of people starved and millions died.
* Lenin also instituted **slave labor camps**. Anyone who disagreed with Lenin's rule was sent to work at one of these camps, where millions more suffered and died.
* And, he executed his detractors to silence their voices. During the Red Terror, hundreds of thousands of detractors were put to death.

After Lenin, a series of dictators ruled Russia, chosen by the Politburo, the executive committee of the Communist Party.

**A Command Economy**

Unlike the United States and other countries, in which the government did not get overly involved in business and the economy, the Russian government supervised very aspect of the economy. The state decided which goods would be produced, in what quantity and by what deadline. It decided which factories would produce specific goods and the prices of those goods, as well as the wages that would be earned by workers. This is a state-controlled economy, the opposite of a free-market economy run according to the policy of “laissez faire,” or “hands off” by the government.

Starting in 1928, the Russian economy operated according to a series of five-year plans that decided on production priorities from the top down. Most five-year plans emphasized heavy industrial production at the expense of consumer goods. Trailers, trucks and tanks were manufactured, while everyday consumer goods like household furnishing and appliances, clothing and shoes, hygiene products and personal automobiles were low priorities. So few consumer goods were produced that the economies of Russia and other Eastern European countries were sometimes called “shortage economies.” This means that there were always shortages of consumer goods. Even though people had money to buy, there was not much to be bought.

**Communism in Other Countries**

Russia was not the only Communist country. After World War II, China became, and still is, a country ruled by the Communist Party. Other communist countries today are Cuba, Laos, North Korea and Vietnam, and in each of these countries, communism takes a slightly different form.

In the West, we often have a negative view of communism, partly because the systems of government in those countries tend to be less democratic than most Western countries. In China, for instance, there is only one political party, the Communist Party. Most decisions that affect the whole country are made by a very few individuals at the top of the Communist Party leadership, and there are no real elections as there are in true democracies. The government also controls many more aspects of people’s lives, such as where they can live and work.

China is a good illustration of the difference between communism as an economic system, and the fact that most of us have come to see “communism” as a form of government. In fact, while China has a government that controls more aspects of people’s lives, and concentrates more power in the hands of a few leaders, its economic system has actually become less communist and more like capitalist countries. While there remain state-owned enterprises, now private individuals can also own stores, businesses, and factories.

China and Russia are both good examples of the differences between *the theory and practice of* communism. The theory of communism is that it is possible to have a communal system of living in which every individual is equal to everyone else in all ways, including wealth. This ideal has not been achieved in either Russia, China, or any other communist country. Indeed, in 1991, the Soviet Union broke apart and Russia abandoned communism.

**Words to Know**

Capitalism Communism

Industrial Revolution Karl Marx

Adam Smith Working class

Invisible Hand Red terror

Equilibrium price slave labor camps

Demand command economy

Corporation proletariat

Laissez Faire bourgeoisie

Competition

Monopoly

Great Depression

New Deal

Safety net