

# 5 Economic Systems

*What functions must an economy perform?*

*How is the economy linked to the society?*

*How can we judge whether the economy is serving the society well?*

We now need to establish some principles on which our explorations into political economy can be based. Having reviewed in the preceding four chapters the broad sweep of issues with which contemporary political economists are concerned, it is time for a change of gear. We must consider more carefully the nature of the economic enquiry itself. This means discussing what an economy is and does, what forms economic organisation can take, and how economic activity links with social structure. It also requires some consideration of how we can judge the performance of an economy in meeting social goals. Through looking at these issues we also start to see some of the sources of disagreement and controversy in political economic enquiry.

## Economic fundamentals

The economy can be understood most simply as the means whereby goods and services are produced, exchanged, and distributed among the members of a society. Incomes and wealth are generated through these processes of production, exchange, and distribution. These incomes are more or less evenly shared, creating outcomes that can be egalitarian or markedly inequalitarian. The wealth can be more or less wisely used; it can be used for immediate consumption, for reinvestment in increasing the productive capacity of the economy, or for wasteful purposes associated with war or environmental destruction, for example. Over time, the volume and value of the income-generating economic activities may either expand or contract, causing either economic growth or decline.

Looking at the economy in this way draws attention, first and foremost, to the system by which we provide for our needs, individually and collectively. At a minimum, we need food, clothing, and shelter. Providing for those needs is the most basic economic activity; thus,

farmers and fishers are more fundamental to economic activity than are financiers. By similar reasoning, making clothes and building houses are also basic economic activities, although many of the products now made—designer wear and suburban ‘McMansions’—go far beyond what is necessary to satisfy our basic needs. Indeed, a vast array of products is made in modern economies, manufactured to gratify desires that are psychological rather than physiological. Notwithstanding the difficulty of distinguishing needs from wants in practice, the point remains—that the basic function of the economy is the practical task of ‘provisioning’.<sup>1</sup> The processes by which those products are exchanged, and how the resulting incomes and wealth are distributed, may involve complex financial arrangements. That may explain the common perception that economics is ‘all about money’. However, as defined here, the more basic and universal feature of all economic systems is the use of tangible resources—natural, human, and manufactured—for making goods and services.

Economics is the discipline that studies these processes. It analyses the production and exchange of goods and services, the distribution of income and wealth, the disposition of that income and wealth, and the material influences on social progress. Economists have always claimed that, by casting light on these matters, they can help us gain more control over the economic factors that shape our existence. The social purpose of studying economics is to contribute to human betterment. By understanding the causes of poverty and recessions, for example, economists can contribute to pushing back at least some of the constraints on our well-being, individually and collectively.

So, wherein lies the distinction between economics and political economy? It rests largely on the claim by contemporary political economists that mainstream economists have, in practice, abandoned this social mission in favour of theories (about ‘pure’ markets) that reveal little about how the economy actually operates. Political economy is distinguished by its emphasis on the broader view of economic enquiry, its social purpose and its political application. This gives a distinctively interdisciplinary character to political economy, albeit with material economic concerns as the central focus. Political economy also emphasises that the way in which economic issues are analysed cannot be wholly value free. The selection of issues for study, the distinctive assumptions made, and the form of investigation are all pervaded by judgments. The important thing is to make the values explicit, rather than leave them implicit, masked by claims about a scientific status for the discipline. Other features of political economy follow: the emphasis on evolutionary processes rather than on equilibrium; the emphasis on equity and sustainability as well as efficiency; and the emphasis on all the institutions involved in shaping economic outcomes. The focus is on understanding the social character of economic activity.

## Economy and society

What shapes the relationship between economy and society? The functioning of the economy does not take place separately from other aspects of life. Political economists have repeatedly

stressed the need to study the social embeddedness of the economic system to analyse how it is related to the construction and reproduction of social order.<sup>2</sup> There are at least seven dimensions of this interaction between the economy and society, as follows.

## Nature

All economic activity takes place in an environmental context. The availability and quality of natural resources—land, air, and water—is fundamental to life and to all forms of social existence. The particular forms of economic activity associated with modern societies make heavy demands on the natural resource endowment. Land is converted from wilderness to various forms of agricultural, residential, commercial, and industrial uses. Coal, oil, iron ore, bauxite, and a host of other precious mineral products are extracted from beneath the ground and transformed into products for human use. Water is used for irrigation, industrial cooling, and dispersal of wastes. Apart from its use in sustaining life itself, air is used as a receptacle for emissions resulting from economic activities. How these processes of resource use are organised and managed—whether based on a restorative or rapacious relationship to nature—is the most fundamental feature of economy and society.

## Markets

How the goods made by applying human resources to nature are produced and distributed also has a major bearing on the economy–society relationship. Production for exchange is a pervasive feature of modern economic activity. Markets are where those exchanges typically occur. Market interactions impose discipline on the participants in the economic system: sellers cannot sell whatever they want for whatever price they like, nor can consumers buy whatever they want for whatever they would like to pay. Exchanges will only occur when they are expected to be mutually advantageous. An effective market mechanism creates the conditions for such outcomes, but it cannot thereby resolve all economic problems. There may, for example, be circumstances in which no goods and services are available because of interruptions to the production process, or because maldistribution of income causes buyers to come to the market with markedly uneven purchasing power. An economy in which markets play a central role depends on certain social underpinnings—an acceptance of commercial contracts as a legitimate and enforceable foundation for personal interactions, for example. In turn, a market economy tends to leave its clear stamp on the prevailing social structures and attitudes, emphasising material acquisition as the key indicator of social worth and social position.

## State

Economic processes of production, exchange, and distribution can be organised by the state rather than left to the operation of market forces. The state comprises all the institutions of national and regional administration, including the government, the public service, and the judiciary. Its most direct economic role in production is through public-sector business

enterprises—hence the importance of political decisions about the balance between nationalisation and privatisation. Its other regulatory activities and its tax revenue-raising and expenditure functions are also fundamentally important in shaping economic activity in the private sector of the economy. How these aspects of state involvement in the economic system are constructed and blended is an intensely political issue. A society in which economic provision is state centred can be expected to be more collectivist in character than one in which private enterprise dominates. How the state is controlled—whether through democratic or authoritarian processes—then becomes the key issue.

## Class

Class relationships are another central feature of the interaction between economy and society. If, for example, some people own the means of production (such as factories, tools, and machines), while others have only their labour to sell, that gives rise to a distinct class divide. It is likely to be associated with sharp differences in income, wealth, and power. These differences may be the source of social conflict, although some degree of cooperation between classes is essential if the economic system is to continue to function. Indeed, it is this uneasy blend of conflict and cooperation that is the hallmark of a class society. It should also be noted that, while class differences are rooted in economic conditions, their social manifestations—differences in social status and social behaviour, for instance—are often very complex.

## Gender and ethnicity

Gender and ethnicity commonly interact with class in shaping the economy and society. A sexual division of labour is said to characterise economic arrangements in which men and women characteristically do different jobs. Likewise, people of different ethnic backgrounds are often located in different segments of the labour market. In both cases, this can be the result of discrimination—although it may be deeply rooted in economic and social institutions and not merely the result of personal prejudice by individual employers. Sexism and racism are pervasive ideologies, and sexist and racist practices can be institutionally embedded. They cause inequalities of economic opportunities and economic rewards to be structured according to gender and ethnicity.

## Social capital

Some social scientists have argued that the effectiveness of an economy depends significantly on the character of interpersonal relationships within the society. Where there are strong networks of social interaction, fostering social cohesion and trust, there is said to be a high quality of social capital. This tends to be conducive to higher economic productivity than in societies that are more individualised, fragmented, or conflicted. But how to define and measure social capital—indeed, the usefulness of the concept itself—remains controversial.<sup>3</sup> The use of the term ‘capital’ in this context is particularly contentious, because networks of social relationships are very different from ‘capital’ as

it is more generally used in economics to refer to financial and physical assets used in producing goods and services.

## Ideology

Helping the economy and society to maintain stability and continuity are beliefs about the desirability—even ‘naturalness’—of all the foregoing arrangements. This is the role of ideologies. These are systems of belief that shape behaviour, individually and collectively. In general, one would expect such ideologies to reflect the existing material economic conditions. The association between consumerist values and an economic system geared to the production of ever more goods and services is an obvious example. However, dominant ideologies are continually challenged by rival, dissident beliefs. Therein lies an important impetus for change in economic and social organisation.

These seven dimensions of the relationship between the economy and society can be regarded as the glue that holds the political economic system together and determines how it works. The relative importance of nature, market, state, class, gender and ethnicity, social capital, and ideology in shaping economic and social order varies enormously, from country to country and over time. How well these different arrangements work is also the focus of endless debate in political economy. The glue can sometimes fail and, when it does, the system comes unstuck.

### BOX 5.1

#### ELINOR OSTROM (1933–)



Elinor Ostrom is perhaps the least well-known person to have won the Nobel Prize for Economic Sciences. When she was given the award in 2009, academic economists around the world were saying ‘Elinor who?’ So it is ironic that we begin the series of ‘thumbnail sketches’ of influential economists in this book by paying attention to her work. Is there really any sound basis for setting her in the company of Adam Smith, Karl Marx, J. M. Keynes, and Milton Friedman, for example? Is it just that she was the first female winner of the Economics Nobel, following 62 males? That gender bias in the history of the economics profession is notable—but not immutable, of course. Yet the greater significance, in the context of this chapter in the book, is Ostrom’s challenge to the market–state dualism in economic thought.

Much economic discourse is concerned with considering the relative roles of market and state in creating and allocating economic resources. This market–state dualism is particularly evident when economic policies are discussed, advocated, or criticised. Should the use of economic resources be left to individuals in the market place, making personal choices that may serve a self-interest but sometimes violate broader community interests? How much direct responsibility should the state take for the

provision of goods and services, allocating them according to social need? A tendency to polarised political positions—libertarian or statist—is commonly evident in such debates, although there are intermediate positions emphasising the need for regulated markets, for example.

Markets and states—and blends thereof—are not the only means through which an economy can be managed, however. As this chapter has already demonstrated, a broader array of social institutions is commonly involved. Indeed, that may be essential for achieving the goals of efficiency, equity, sustainability, and compatibility with broader social goals. Ostrom’s work helps us to understand why.

Consider the challenge of managing common resources. It is often discussed by economists in terms of ‘the tragedy of the commons’. The usual inference is that collectively owned resources will be overused because, without a price mechanism to charge for personal use, there is a tendency for everyone to take more than their fair share—to the long-run detriment of all. The classic example is those lands in medieval societies where all peasants could freely graze their livestock. According to the commonly cited study by Garrett Hardin,<sup>4</sup> these lands became degraded because they were overused. Only if they could be converted into smaller lots for which there are private property rights would more sustainable outcomes be achieved. It is a powerful and influential story, but it is a misreading of history. The quality of common land was actually maintained for centuries through a complex set of social arrangements shaping customary use. It was the privatisation of other land that created much of the eventual problem, as more people were forced to try to eke out a living on the common land.

Ostrom’s approach to studying how common resources can be effectively managed relies on experimental methods as well as historical analysis. She has shown that, when faced with economic circumstances where interdependence of the actors is crucial to the outcome, quite sophisticated ways of addressing and managing that interdependence usually emerge. Political economic possibilities are not reducible to the linear dimension of markets versus states. A broader array of socioeconomic possibilities needs consideration.

## Evaluating economic performance

Understanding economic organisation—its different forms, diverse interpretations, and social implications—is the first task of political economy. The second is to evaluate economic performance. If political economy is to contribute to social progress, this essentially normative dimension is necessary in our deliberations. We need to know what works well and what does not. For this purpose, we need reasonably clear criteria of evaluation. The following four are suggested.

### Efficiency

Any economic system should make efficient use of the available resources—natural, human, and manufactured. However, what efficiency really means in this context remains open

to debate. The avoidance of waste is certainly implied, but what constitutes waste may itself be a matter of judgment. Is it wasteful to use natural resources to make products that are discarded as junk after their short lifespans? Or is it wasteful not to use all resources at our disposal? Economists have conventionally distinguished three dimensions of efficiency. There is efficiency of resource utilisation: not leaving resources unused, as occurs, for example, whenever there is a significant incidence of unemployment in a region or nation. There is efficiency of resource allocation: ensuring, for example, that the goods and services produced are those that the members of the society actually want to consume. There is efficiency of resource creation: fostering the most productive development of the workforce, for example, or of new production technologies through innovation. For each of these three dimensions we need to remember that efficiency implies a means to particular ends: it is not an end in itself.

## Equity

The economic system should distribute its fruits in accordance with our social standards of equity. Equity implies fairness. Therein, of course, lies plenty of scope for different interpretation. Some people interpret equity as requiring equality of economic outcomes, such as equal incomes for all members of the population. Others stress the more modest goal of equality of opportunity, accepting major income inequalities as long as all have an equal opportunity to succeed. On either reading, inequalities associated with systemic patterns of social differentiation according to class, gender, or ethnicity violate the equity ideal. For practical purposes, the degree of inequality in the overall distribution of income or wealth is usually taken as a rough primary indicator of the extent of equity in different types of economy.

## Sustainability

We also require of an economic system that it be sustainable. In other words, it must be capable of reproducing itself. That means not using non-renewable natural resources, nor using renewable resources at a faster rate than that at which they are replenished. The harmony between the economy and the physical environment is obviously crucial here. Economic growth based on a rapacious relationship to nature clearly fails this environmental sustainability test. Sustainability has its economic and social dimensions, too. Economically, it is crucial that equipment subject to wear and tear through its use in producing goods and services be maintained and/or periodically replaced; consequently, a sustainable economy must involve forgoing some current consumption in order to ensure sufficient productive investment in capital goods. Socially, sustainability also requires that the relationships between classes, genders, and ethnicities be sufficiently stable for people to continue cooperating in economic activity. For this to happen, those relationships must be perceived as legitimate—otherwise, social turmoil, even revolution, may eventuate.

## Compatibility with social goals

The ultimate test of an economic system is whether it serves society well. Does it generate the necessary goods, such as the food, clothing, housing, and other material requisites for a contented society? Does it produce the quality health and educational services necessary for a healthy and well-informed citizenry? Generally, is it conducive to personal and community development, to personal freedom, to cultural enrichment, or to the realisation of spiritual as well as material goals? These are the higher social purposes against which the mundane contributions of the economy need to be judged. Therein lies a host of difficulties: identifying the relevant social goals and their relative importance, deciding how they can be measured or otherwise assessed, and learning how political judgments can be made about trade-offs between them. On such contentious matters there can never be unanimous agreement. There are also good reasons to expect that the character of the economic system will itself have a major bearing on the pattern of prevailing social aspirations—so an objective test is elusive. However, if nothing else, such considerations are a reminder of the need to take a broader view of the economy and of economic progress than that based on the conventional economic indicators.

### BOX 5.2

## THE POLITICAL ECONOMY OF CLIMATE CHANGE

The nature and causes of climate change are contentious, as are the appropriate responses. Complex scientific analysis, as well as political economic judgment, is required. The scientific community has become increasingly concerned about the existence and severity of the problem. Sceptics remain, of course, but what had emerged in the 1980s as a growing concern with the 'greenhouse effect' and 'global warming' had become a worldwide recognition of the climate change problem by the international summit meeting that was held in Kyoto, Japan in 1997. Since that date the Intergovernmental Panel on Climate Change (IPCC) has represented the increasingly strong scientific consensus, emphasising that the threat arises, in substantial measure, from human activities. Although progress in getting global agreement to tackle the problem has been lamentably slow, the need to do so has now become well established.

Burning of coal, oil and other fossil fuels causes the emission of carbon into the atmosphere. As a consequence, the infrared radiation generated by the Sun's warming of the Earth is impeded on its way out, causing the planet to warm and the climate to change. The amount of those emissions—and hence the intensity of global warming and climate change—depends on the volume and nature of economic activity that is carbon generating.

Put most simply, there are three contributory factors in climate change: people, production, and technology. A larger population, other things being equal, means a greater demand on resources and a bigger volume of economic activity. However, it is the material living standards of those people that is crucial. This is where the second element—the production process—kicks in, because the volume of economic production drives the

demand for energy to produce mineral, agricultural, and manufactured goods, and to transport the goods and people. That is why income and the rate of economic growth matters. An extra child in the United States or other affluent nations, for example, adds many times more to the ecological stresses than a child born into a poorer nation. Technology, as the third element, is crucial, too. Technologies for production and transportation that depend on burning fossil fuels are obviously more problematic than those that do not. So dealing with the climate change problem requires attention to these three influences. Some say that a change in technology would be sufficient; others that policies to lower population growth and/or levels of production and consumption are also needed. The character, form, and distribution of economic growth is central to all such concerns.

Solving—or even just reducing—the threat of climate change requires a comprehensive program of economic restructuring and social transition. This is an enormous challenge. It requires consideration of complex ecological, social, economic, political, cultural, and ethical issues. It requires strong commitment to remedial policies. Proponents of making a transition to a sustainable society commonly emphasise that it cannot be just a transition—it must be a just transition. The ‘make the polluter pay’ principle has particular relevance in this context, since it implies the need to put the costs of adjustment onto the individuals, firms, industries, and nations responsible for the most carbon emissions, rather than ‘equality of sacrifice’. The question of who should take the primary responsibility for leading the way towards more environmentally responsible patterns of production and consumption is clearly a political economic rather than a scientific judgment.

Sustainability is the ultimate goal. Its operational definition is tricky, however, because of different economic, social, and ecological conceptions of sustainability. Economic sustainability requires the reproduction of productive capacity, including the replacement of depreciating capital, whether natural or human built. Social sustainability implies the reproduction of acceptable social structures and institutions, producing social cohesion. Ecological sustainability requires the maintenance of biodiversity, ensuring ecological integrity, maintaining the stock of natural capital and providing for intergenerational equity. Putting the three aspects together is necessary but difficult. It is an issue to which we return in Chapter 35 of this book.

## What measure of progress?

The overall performance of a national economy is conventionally measured according to gross domestic product (GDP), which is the sum of the market value of all goods and services produced in a country during a year, irrespective of whether they are produced by individuals, private business enterprises, or government institutions. If this sum is greater than the preceding year’s, then economic growth is said to have occurred. Conversely, no growth or, worse, a decline, is held to be indicative of relative economic failure. League tables, such as Table 4.1, are commonly constructed on GDP per capita to indicate the ranking of the different countries of the world in any one year according to this performance measure. In principle, the

measure can also apply to subnational areas (gross regional product or gross city product) and to the world as a whole (gross planetary product).

Notwithstanding its widespread application, this conventional measure of economic performance is subject to numerous problems.<sup>5</sup>

- It excludes many useful goods and services that are produced directly for personal consumption rather than for sale. Domestic household production—much of it traditionally (and still) performed by women—is of this character.
- It includes expenditure on goods and services whose production is only necessary because of the damage by producing or consuming other things. Expenditures on pollution control devices and vehicle smash repairs are obvious examples. These ‘defensive expenditures’ add to GDP, but it is doubtful that they make a net contribution to community well-being.
- No account is taken of the rundown in the stocks of environmental resources that may occur in the process of producing marketed goods and services.
- The time and effort involved in producing goods and services does not enter into the calculations. So no account is taken of the leisure that is sacrificed in order to produce the output.
- The distribution of the products is also not considered. The production of frivolous, luxury consumption items for the wealthy counts equally with the production of basic necessities for the poor.

Reflecting on these problems and biases, one critic has described conventional national measures, ‘the crown jewels of economic statistics’, as ‘almost trivial indicators of anything worth measuring’.<sup>6</sup> This is an issue to which we return in the final chapter of this book. Meanwhile, the inference is clear—merely increasing the volume and value of marketed economic products does not reliably constitute progress.

## Conclusion

There are various ways in which economic activity can be organised. Identifying nature, the market, state, class, gender, ethnicity, social capital, and ideology as dimensions of economic and social order draws attention to the array of organising principles and institutions. It draws attention to the complexity of the interrelationships between the economy and society.

There are also various ways in which economic performance can be evaluated. Identifying efficiency, equity, sustainability, and compatibility with social goals indicates the most important dimensions. It also draws attention to some of the deficiencies of narrowly constructed conventional economic indicators, such as GDP.

These considerations show why the exercise of judgment is necessary in political economic analysis. Indeed, the scope of political economic enquiry itself is a matter of judgment. While the economy can be reasonably clearly defined—in terms of production, exchange, and

distribution—there is no line clearly dividing the economy from society. By similar reasoning, there is no clear separation of economics, as a form of enquiry, from the other social sciences. There are also inescapably normative elements involved in evaluating economic systems. No wonder that views about the nature of the capitalist economy and how well it serves social goals are so diverse.

#### KEY POINTS

- Economic systems have distinctive functions: producing goods and services, facilitating the exchange of those products, and distributing income and wealth.
- How well the economy serves the society can be evaluated according to criteria such as efficiency, equity, sustainability, and compatibility with broader social goals.
- There is considerable evidence that growth in the production of goods and services and the accumulation of wealth has not been accompanied by a corresponding increase in social well-being.

## 6 Capitalism

*What systems of economic organisation are possible?*

*What is special about capitalism?*

*What are the common features of capitalist economies?*

Economic activity can be organised in various ways in the attempt to satisfy the social purposes identified in the preceding chapter. Communal, slave, feudal, capitalist, and socialist systems are the principal alternatives. Capitalism is evidently the predominant system at the present time. A careful definition of this system is required before studying how it works and making judgments about how well it works. This is attempted in this chapter by contrasting capitalism with other ways in which economic activity can be organised and then by looking in more detail at its distinctive features.

### Alternative economic systems

Economic activity can be organised communally. In small social clusters, for example, people can gather to decide what they will produce, how the tasks will be shared, and how the fruits of their combined economic effort will be distributed and used. These decisions may be strongly influenced by custom and convention. Such has been the case in many tribal societies, a traditional focus in anthropological studies. The term 'primitive communalism' is applied in this context, although the economic and social processes may be highly sophisticated. Whether such communal organisation constitutes a viable basis for a large-scale, industrial economy is a moot point, but the principles and practices are relevant wherever cooperative behaviour needs to be nurtured.

A second possible means of economic organisation is slavery. Historically, slavery has been of considerable significance. Explicit use of force by one class (slave owners) over another (slaves) is the central organising principle here. Violence (or the threat of it) is the driver of economic activity, determining what gets done, by whom, how, where, and when. Slavery