**Economic Systems**

**What you’ll learn to do: differentiate between economic systems and discuss theoretical views of economics**



**Figure 1**. Companies pay to advertise their goods and services in Times Square in New York City, NY. Advertisements are an important facet of the U.S. capitalist economic system. (Photo courtesy of Chris Tagupa/unsplash)

In this section, you’ll examine the basics of economies, which refer to the social institution through which a society’s resources (goods and services) are managed. You will also learn about the development of economies through the transformation of societies.

The Agricultural Revolution led to development of the first economies that were based on trading goods. Mechanization of the manufacturing process led to the Industrial Revolution and gave rise to two major competing economic systems: capitalism and socialism. Under capitalism, private owners invest their capital and that of others to produce goods and services they can sell in an open market. Prices and wages are set by supply and demand and competition. Under socialism, the means of production is commonly owned, and part or all of the economy is centrally controlled by government. There is no nation that is *completely* capitalist or socialist; many countries’ economies feature a mix of both systems.

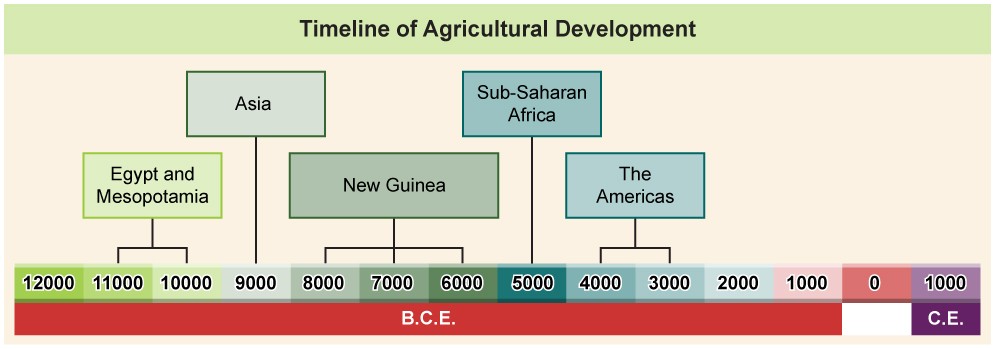
**Systems**

Economy is one of human society’s earliest social structures. In sociology, **economy** refers to the social institution through which a society’s resources are exchanged and managed. The earliest economies were based on trade, which was often a simple exchange in which people traded one item for another. Our earliest forms of writing (such as Sumerian clay tablets) were developed to record transactions, payments, and debts between merchants. As societies grow and change, so do their economies—the economy of a small farming community is very different from the economy of a large nation with advanced technology.

The dominant economic systems of the modern era are capitalism and socialism, and there have been many variations of each system across the globe. Countries have switched systems as their rulers and economic fortunes have changed. For example, Russia has been transitioning to a market-based economy since the fall of communism in that region of the world. Vietnam, where the economy was devastated by the Vietnam War, restructured to a state-run economy in response, and more recently has been moving toward a socialist-style market economy.

**The Agricultural Revolution**

The first true economies arrived when people started raising crops and domesticating animals, both of which required staying in one place for a period of time. Although there is still a great deal of disagreement among archeologists as to the exact timeline, research indicates that agriculture began independently and at different times in several places around the world. The earliest agriculture was in the Fertile Crescent in the Middle East around 11,000–10,000 years ago. Next were the valleys of the Indus, Yangtze, and Yellow rivers in India and China, between 10,000 and 9,000 years ago. The people living in the highlands of New Guinea developed agriculture between 9,000 and 6,000 years ago, while people were farming in Sub-Saharan Africa between 5,000 and 4,000 years ago. Agriculture developed later in the western hemisphere, arising in what would become the eastern United States, central Mexico, and northern South America between 5,000 and 3,000 years ago (Diamond 2003).



**Figure 3.**Agricultural practices have emerged in different societies at different times. (Information courtesy of Wikimedia Commons)

Agriculture began with the simplest of technologies—for example, a pointed stick to break up the soil—but advanced dramatically when people harnessed animals to pull an even more efficient tool for the same task: a plough. With this new technology, one family could grow enough crops not only to feed themselves but also to feed others. Knowing there would be abundant food each year as long as crops were tended, led people to abandon the nomadic life of hunter-gatherers and settle down to farm.

The improved efficiency in food production meant that not everyone had to toil all day in the fields. As agriculture grew, new jobs emerged, along with new technologies. Excess crops needed to be stored, processed, protected, and transported. Farming equipment and irrigation systems needed to be built and maintained. Wild animals needed to be domesticated and herds shepherded. Economies begin to develop because people now had goods and services to trade. At the same time, farmers eventually came to labor for the propertied ruling class.

As more people specialized in nonfarming jobs, villages grew into towns and then into cities. Urban areas created the need for administrators and public servants. Disputes over ownership, payments, debts, compensation for damages, and the like led to the need for laws and courts—and the judges, clerks, lawyers, and police who administered and enforced those laws.

At first, most goods and services were traded between small social groups by exchanging one form of goods or services for another known as bartering (Mauss 1922). This system only works when one person happens to have something the other person needs at the same time. To solve this problem, people developed the idea of a means of exchange that could be used at any time: that is, money. **Money** refers to an object that a society agrees to assign a value to so it can be exchanged for payment. In early economies, money was often objects like cowry shells, rice, barley, or even rum. Precious metals quickly became the preferred means of exchange in many cultures because of their durability and portability. The first coins were minted in Lydia in what is now Turkey around 650–600 B.C.E. (Goldsborough 2010). Early legal codes established the value of money and the rates of exchange for various commodities. They also established the rules for inheritance, fines as penalties for crimes, and how property was to be divided and taxed (Horne 1915). A symbolic interactionist would note that bartering and money are systems of symbolic exchange that require the negotiation of value. Monetary objects took on a symbolic meaning, one that carries into our modern-day use of cash, checks, and debit cards.

As city-states grew into countries and countries grew into empires, their economies grew as well. When large empires broke up, their economies broke up too. The governments of newly formed nations sought to protect and increase their markets. They financed voyages of discovery to find new markets and resources all over the world, which ushered in a rapid progression of economic development.

Colonies were established to secure these markets, and wars were financed to take over territory. These ventures were funded in part by raising capital from investors who were paid back from the goods obtained. Governments and private citizens also set up large trading companies that financed their enterprises around the world by selling stocks and bonds.

Governments tried to protect their share of the markets by developing a system called mercantilism. **Mercantilism** is an economic policy based on accumulating silver and gold by controlling colonial and foreign markets through taxes and other charges. The resulting restrictive practices and exacting demands included monopolies, bans on certain goods, high tariffs, and exclusivity requirements. Mercantilistic governments also promoted manufacturing and, with the ability to fund technological improvements, they helped create the equipment that led to the Industrial Revolution.

**The Industrial Revolution**

Until the end of the eighteenth century, most manufacturing was done by manual labor. This changed as inventors devised machines to manufacture goods. A small number of innovations led to a large number of changes in the British economy. In the textile industries, the spinning of cotton, worsted yarn, and flax could be done more quickly and less expensively using new machines with names like the Spinning Jenny and the Spinning Mule (Bond 2003). Another important innovation was made in the production of iron: coke from coal could now be used in all stages of smelting rather than charcoal from wood, which dramatically lowered the cost of iron production while increasing availability (Bond 2003). James Watt ushered in what many scholars recognize as the greatest change, revolutionizing transportation and thereby the entire production of goods with his improved steam engine.

As people moved to cities to fill factory jobs, factory production also changed. Workers did their jobs in assembly lines and were trained to complete only one or two steps in the manufacturing process. These advances meant that more finished goods could be manufactured with more efficiency and speed than ever before.

The Industrial Revolution also changed agricultural practices. Until that time, many people practiced **subsistence farming** in which they produced only enough to feed themselves and pay their taxes. New technology introduced gasoline-powered farm tools such as tractors, seed drills, threshers, and combine harvesters. Farmers were encouraged to plant large fields of a single crop to maximize profits. With improved transportation and the invention of refrigeration, produce could be shipped safely all over the world.

The Industrial Revolution modernized the world. With growing resources came growing societies and economies. Between 1800 and 2000, the world’s population grew sixfold, while per capita income saw a tenfold jump (Maddison 2003). While many people’s lives were improving, the Industrial Revolution also birthed many societal problems. There were inequalities in the system. Owners amassed vast fortunes while laborers, including young children, toiled for long hours in unsafe conditions. Workers’ rights, wage protection, and safe work environments are issues that arose during this period and remain concerns today.

**Capitalism and Socialism**

Mechanization of the manufacturing process led to the Industrial Revolution which gave rise to two major competing economic systems: capitalism and socialism. Under capitalism, private owners invest their capital and that of others to produce goods and services they can sell in an open market. Prices and wages are set by supply and demand and competition. Under socialism, the means of production is commonly owned, and part or all of the economy is centrally controlled by government. Several countries’ economies feature a mix of both systems.

**Capitalism**

Scholars don’t always agree on a single definition of capitalism. For our purposes, we will define **capitalism** as an economic system in which there is private ownership (as opposed to state ownership) and where there is an impetus to produce profit, and thereby wealth. This is the type of economy in place in the United States today. Under capitalism, people invest capital (money or property invested in a business venture) in a business to produce a product or service that can be sold in a market to consumers. The investors in the company are generally entitled to a share of any profit made on sales after the costs of production and distribution are taken out. These investors often reinvest their profits to improve and expand the business or acquire new ones. To illustrate how this works, consider this example. Sarah, Antonio, and Chris each invest $250,000 into a start-up company that offers an innovative baby product. When the company nets $1 million in profits its first year, a portion of that profit goes back to Sarah, Antonio, and Chris as a return on their investment. Sarah reinvests with the same company to fund the development of a second product line, Antonio uses his return to help another start-up in the technology sector, and Chris buys a yacht.

To provide their product or service, owners hire workers to whom they pay wages. The cost of raw materials, the retail price they charge consumers, and the amount they pay in wages are determined through the law of supply and demand and by competition. When demand exceeds supply, prices tend to rise. When supply exceeds demand, prices tend to fall.

When multiple businesses market similar products and services to the same buyers, there is competition. Competition can be good for consumers because it can lead to lower prices and higher quality as businesses try to get consumers to buy from them rather than from their competitors.

Wages tend to be set in a similar way. People who have talents, skills, education, or training that is in short supply and is needed by businesses tend to earn more than people without comparable skills. Competition in the workforce helps determine how much people will be paid. In times when many people are unemployed and jobs are scarce, people are often willing to accept less than they would when their services are in high demand. In this scenario, businesses are able to maintain or increase profits by not increasing workers’ wages.

**Socialism**

**Socialism** is an economic system in which there is government ownership (often referred to as “state run”) of goods and their production, with an impetus to share work and wealth equally among the members of a society. Under socialism, everything that people produce, including services, is considered a social product. Everyone who contributes to the production of a good or to providing a service is entitled to a share in any benefits that come from its sale or use. To make sure all members of society get their fair share, governments must be able to control property, production, and distribution.

The focus in socialism is on benefitting society, whereas capitalism seeks to benefit the individual. Socialists claim that a capitalistic economy leads to inequality, with unfair distribution of wealth and individuals who use their power at the expense of society. Socialism strives, ideally, to control the economy to avoid the problems inherent in capitalism.

Within socialism, there are diverging views on the extent to which the economy should be controlled. One extreme believes all but the most personal items are public property. Other socialists believe only essential services such as healthcare, education, and utilities (electrical power, telecommunications, and sewage) need direct control. Under this form of socialism, farms, small shops, and businesses can be privately owned but are subject to government regulation.

The other area on which socialists disagree is on what level society should exert its control. In **communist**countries like the former Soviet Union, or modern-day China, Vietnam, and North Korea, the national government controls both politics and the economy, and many goods are owned in common. Ideally, these goods would be available to all as needed, although this often plays out differently in theory than in practice. Communist governments generally have the power to tell businesses what to produce, how much to produce, and what to charge for it. There are varying practices within and between communist nations; for example, while China is still considered to be a communist nation, it has adopted many aspects of a market economy. Other socialists believe control should be decentralized so it can be exerted by those most affected by the industries being controlled. An example of this would be a town collectively owning and managing the businesses on which its residents depend.

Because of challenges in their economies, several of these communist countries have moved from central planning to letting market forces help determine many production and pricing decisions. **Market socialism** describes a subtype of socialism that adopts certain traits of capitalism, like allowing limited private ownership or consulting market demands. This could involve situations like profits generated by a company going directly to the employees of the company or being used as public funds (Gregory and Stuart 2003). Many Eastern European and some South American countries have mixed economies. Key industries are nationalized and directly controlled by the government; however, most businesses are privately owned but regulated by the government.

**Socialism in Practice**

As with capitalism, the basic ideas behind socialism go far back in history. Plato, in ancient Greece, suggested a republic in which people shared their material goods. Early Christian communities believed in common ownership, as did the systems of monasteries set up by various religious orders. Many of the leaders of the French Revolution called for the abolition of all private property, not just the estates of the aristocracy they had overthrown. Thomas More’s *Utopia*, published in 1516, imagined a society with little private property and mandatory labor on a communal farm. A *utopia* has since come to mean an imagined place or situation in which everything is perfect. Most experimental utopian communities have had the abolition of private property as a founding principle.

Modern socialism really began as a reaction to the excesses of uncontrolled industrial capitalism in the 1800s and 1900s. The enormous wealth and lavish lifestyles enjoyed by the propertied classes contrasted sharply with the miserable conditions of the workers.

By far the most important influential thinker on socialism is Karl Marx. Through his own writings and those with his collaborator, industrialist Friedrich Engels, Marx used a scientific analytical process to show that throughout history, the resolution of class struggles caused economic and cultural changes. He saw the relationships evolving from slave and owner, to serf and lord, to journeyman and master, to worker and owner. Neither Marx nor Engels thought socialism could be used to set up small utopian communities. Rather, they believed a socialist society would be created after workers rebelled against capitalistic owners and seized the means of production. They felt industrial capitalism was a necessary step that raised the level of production in society to a point where it could then be reconfigured so as to produce a more egalitarian socialist and then communist state (Marx and Engels 1848).