- capitalist market economies vs. socialist planned economies:
    - the extreme distinction between market and planned economies is often used
    - the textbook discusses the "march to markets" to refer to both the transition from socialism in centrally planned countries and the increasing liberalization in LDCs
    - the difference in efficiency between a market and planned system depends largely on how each deals with 1) information and 2) incentives
- incentives:
    - it is argued that the profit motive is the most reliable way to increase output, cut costs, innovate, and meet unmet wants
    - in socialist economies, public-mindedness was an insufficient incentive, so promotions and raises were offered to managers who met the goals of government planning; although these might have helped managers achieve quantitative goals, they did not encourage them to cut costs, innovate, and meet unmet needs
- advantages and disadvantages of market economies and planned economies:

Market Economy		Planned Economy	
Advantages	Disadvantages	Advantages	Disadvantages
1. better provision of incentives	1. the market satisfies demand but might not meet needs	1. successful at rapid industrialization and structural change	1. enterprises tended to be oriented toward increasing quantity of output but not quality
2. better uses local information and conveys global information more cheaply (in prices)	2. public goods not automatically supplied	2. tended to have less income and wealth inequality and higher levels of literacy and basic health care	2. economies as a whole were not technologically dynamic
	3. market power – monopolies, cartels, etc.		3. despite high saving rate, growth was slowed by low productivity of capital (high *s*, also high *v*)
	4. possible negative macroeconomic outcomes		4. output mix lopsided – producer goods vs. consumer goods and agriculture
	5. structural changes might be difficult		5. political repression

- advantages of a market economy:
    1) incentives:
        - the profit-motive has been the best way to motivate; although people can be motivated to work for moral commitments, etc., this has not worked on a large scale for a national economy; changing people's psychology through propaganda did not work over a sustained time period
        - mimicking market incentives for managers helped meet physical quantity goals, but did not help reduce cost, create better products, etc.;

this is similar to the problem with paying workers on a piece-rate basis (workers neglect quality, maintenance of equipment, etc.)

2) information:
   • in a market economy, local decision makers use their information without having to convey it up a decision hierarchy; the global information they need is transmitted to them through the price system; prices are an automatic byproduct of exchanges in markets
   • information does not travel to a central bureau in a market economy

• disadvantages of a market economy – these can sometimes remedied by government intervention:

1) the market satisfies demand but might not meet needs:
   • the market will provide a good if people are willing to pay and have the purchasing power
   • however, needs might not be backed by purchasing power
   • thus, this explains why luxuries might be produced instead of necessities (food, etc.)
   • the government could intervene and redistribute purchasing power
2) public goods:
   • a public good has the characteristics of nonexcludability and nonrivalness
   • nonexcludability - it is costly or impossible to prevent someone who did not pay from consuming
   • nonrivalness – one person's consumption does not affect another person's consumption; for example: an apple (rival) versus a lecture (nonrival))
   • the government could intervene by supplying public goods because private firms will not
3) market power – monopolies, cartels, etc.:
   • monopolies, cartels, etc. will produce inefficient quantities because they try to maximize profit
   • the government could also intervene
4) possible negative macroeconomic outcomes:
   • negative macroeconomic outcomes include price instability, unemployment, and underemployment of factories during low points of the business cycle
   • the government could correct price instability but it requires people to have faith that government intervention will solve the problem
5) structural change might be difficult:
   • planners, theorists, etc. have worried that a poor country will stay poor as long as it produces labor-intensive products (such as primary products)
   • a poor country will want to change the structure of its economy so that it will be more capable of producing manufactured goods and be more self-reliant, on the theory that only industrialized countries can raise their standard of living
   • however, structural change might not happen through the market because the market might encourage continuance of the economy's

structure; for example, if labor is cheap and capital is scarce in an economy, then manufactured goods cannot be produced cheaply; according to the theory of comparative advantage, this economy should not produce manufactured goods (it will already be producing the goods it is suited for)
• thus, China and the Soviet Union tried to push their economies toward industrialization; other nonsocialist countries tried protectionism (such as import substitution industrialization)

• advantages of a planned economy:
1) successful at rapid industrialization and structural change:
• the rate of structural change was high in the 1930s in the Soviet Union and in the 1950s and 1960s in China
2) tended to have less income and wealth inequality and higher levels of literacy and basic health care:
• for example, China and India before liberalization measures in the 1980s had similar per capita incomes; however, primary education levels, literacy, and life expectancy were higher and infant mortality was lower in China because of government expenditures
• planned economies were not perfectly egalitarian, even in theory; the Marxist theory (followed by the USSR) supported unequal distribution of income for unequal work but was associated with greater equality if only because financial capital and land were not privately owned
• regional differences were not eliminated after economies became planned, but some income inequalities were reduced

• disadvantages of a planned economy:
1) enterprises tended to be oriented toward increasing quantity of output but not quality:
• enterprises were poor at reducing cost, innovating, and improving output
2) economies as a whole were not technologically dynamic:
• because there were few incentives to innovate, innovations were limited; the exceptions to this were the military and rocket science
• most technology was borrowed from capitalist economies; in the 1950s the Soviet Union was using the West's 1930s technology; China later borrowed the Soviet Union's 1950s technology (which was the West's 1930s technology)
3) despite high saving rate, growth was slowed by low productivity of capital (high s, also high v):
• planned economies had high saving rates (25-30%) because the saving rate was determined by the government
• because planned economies used inappropriately capital-intensive technologies, they did not use capital efficiently; however, without price signals, decision makers did not know what technologies were efficient
4) output mix lopsided – producer goods vs. consumer goods and agriculture:
• planned economies encouraged production of producer goods, instead of production of consumer goods and agriculture

- the emphasis on heavy industry became a problem for countries transitioning from planned economies because factories became redundant

5) political repression:
   - it could be argued that political repression occurred because the Soviet Union and China were encircled by enemies
   - however, all countries with communist rule and socialist systems used repression to maintain rule
   - attempts to use moral incentives were associated with terror (such as the killing of millions in famines and purges)
   - since government ownership of the means of control and dictation of economic production has never been associated with civil liberties, it can be argued that this is an unavoidable cost of a planned system

- what countries tried planned economies?
  - China (about half the developing world), Cuba, and North Vietnam have planned economies
  - other countries that tried socialism include Chile, Tanzania, Peru, Mozambique, and others
- many nonsocialist developing countries have used planning-type controls for development:
  - these economies lay somewhere between socialist and market economies; for example: Pakistan, Brazil, and others retained private ownership of land and capital but have had high government controls (for example, because of import substitution industrialization (ISI) policies)
  - the government may intervene in the operation of the price system, perhaps by fixing the exchange rate or capping the interest rate
  - interventions lead to prices that do not appropriately reflect the scarcity of resources; however, scarcity would be reflected by prices in a market economy
  - an example of a planning-type control: an overvalued exchange rate (as part of ISI) will lead to a greater demand for imports than a country's exports can support (exporting becomes harder because of the overvalued exchange rate)
  - in the 1980s and 1990s governments have decided to move toward less regulated economies
- rent-seeking:
  - a rent is a return to a factor above its opportunity cost (any income earned by the supplier of the factor of production above the income earned were it put to the next best alternative use); because land has no alternative use (or does not require human effort to come into being), all income earned from land is considered rent
  - rent can also be thought of as a windfall or an unearned income
  - when scarcity is artificially created, rents are also created:

  For example, if there is a large demand for an imported food and at the world price and exchange rate it costs a certain amount, then limiting imports makes the food artificially scarce. Because of the scarcity, the domestic price rises. Anybody who purchases the imported good could resell it at the higher domestic price and receive a rent. Bureaucrats will give permits to import the food to firms. Firms will compete over these licenses because they can make a windfall profit from selling the imported food. Entrepreneurs will spend time on rent seeking, such as by making connections with bureaucrats, instead of spending time reducing their firm's costs, innovating, etc. Because managerial effort could go to either running firms or rent-seeking (which is profitable to the individual but not to society), controls will lead to inefficiency because managers will spend time rent-seeking instead of managing their firms.

• implementing market reforms in either centrally planned economies or market economies with heavy controls:

1. stabilize the macroeconomy:
   • stabilization policies attempt to reduce or eliminate inflation, such as by reducing government budget deficits
   • the International Monetary Fund (IMF) and World Bank (WB) promote stabilization packages to guide countries
   • page 173, figure 5-1 shows the empirical relationship between the inflation rate and growth rate; the countries with the highest growth rates had low levels of inflation
   • page 174, figure 5-2 shows the empirical relationship between the overvaluation of currency and the growth rate; the figure uses the black market premium, which is the percent over the official exchange rate that currency is traded on the black market; the black market premium is a measure of how much the prices of foreign currencies differ from market rates; overvalued currencies correlate with lower economic growth; the high growth countries had black market premiums equal to 0, indicating their exchange rates were at market rates
2. dismantle controls:
   • dismantling controls means eliminating barriers to market activity that prevent the economy from moving toward the equilibrium without the distortions
   • these controls include: limiting the quantity of imports, instituting a ceiling on the interest rate, etc.
   • eliminating controls would help prices reflect scarcity
3. ensure competition:
   • it is better to remove barriers when competition will follow, but removing controls is not enough to ensure competition because conditions favoring monopolies might exist
   • in order to maximize profit, a monopoly will restrict the supply of goods and services, and prices will be higher than what would be most efficient
   • the government could intervene to break-up monopolies
   • opening up an LDC to international trade could make it more competitive and efficient; because most LDCs have small populations, it might be most efficient to have only one domestic firm in an industry (for example, only one domestic firm producing cars); thus, protecting this domestic industry would give that firm a monopoly in the home market, whereas allowing competition from foreign firms would force it to act competitively
4. move toward scarcity prices:
   • a theme of neoclassical economics and development economics is the importance of "getting prices right"
   • resource prices determined by the competitive process in a market economy tell decision makers the value of the resources to the economy
   • controls such as fixed foreign exchange rates (which make foreign exchange cheap because the exchange rates tend to be overvalued), ceilings on interest rates (which

make capital cheap), etc. are not socially optimal because these distortions do not let prices reflect the cost of resources to society, so they lead to privately profitable decisions that are not socially optimal

5. increase responsiveness to market signals:
   • to be efficient, an economy needs decision makers who respond to market signals; however, if decision makers, such as those in government enterprises, are more concerned with pleasing whoever hired them or protecting jobs, then they might not be responsive to prices
   • to resolve this inefficiency, the textbook suggests privatization of government enterprises so that decision makers will respond to profit; according to neoclassical economics, profit-seeking in a decentralized economy without government controls leads to social optimality

• two ways to transition from a planned economy to a market economy:
   1. shock therapy – this transition is rapid and was used by Poland and some other countries
   2. gradual transition – this was used by China and some other countries