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*FOUNDATIONS OF ECONOMIC HISTORY
& THE HISTORY OF ECONOMIC THOUGHT*

THIRD EDITION

Mark Maier • Steven White

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THE 1ST CHAPTER

Foundations of Economic History & The History of Economic Thought

Third Edition

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~~Glendale College~~

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Where Does a Hershey Bar Come From?



**THE FIRST CHAPTER****Foundations of Economic History & The History of Economic Thought**

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Preface

This booklet is designed to help introduce the study of economics. We would like you to be able to answer two fundamental economic questions: where did our current economic system come from?; and, how have economists attempted to understand our economic system?

In Section One of this booklet we answer the first question by going back in time to look at past economic systems. We identify several types of economies that preceded our current economic system. Section Two of this booklet looks the history of economic thought. Since the 1700s, economists have tried to understand how the economy works—often disagreeing with one another. We will see that these disputes continue to the present day in three major perspectives, each with different solutions to today's economic problems.

We would like to thank students in our economics classes who read earlier versions of this booklet. Their criticisms and suggestions helped us prepare this edition for custom publishing by McGraw-Hill. We would appreciate any additional comments or suggestions you may have. Please send them to us at Glendale College, Glendale, CA 91208 (mmaier@glendale.cc.ca.us or swhite@glendale.cc.ca.us).

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July 1998

Introduction

What is economics?

“Economics” is not a fancy word, yet it is tricky to define. Perhaps the best way to define economics is to pose a series of **four basic questions** that summarize what economists study.

1. Who does the work?
2. Who owns the factors of production—tools, machines, factories, land and raw materials?
3. How are the basic economic decisions made about production and distribution?
4. What are peoples' lives like?

Let us put these questions into practice by answering them for today's economic system of the United States.

Factors of Production:

Include **Land, Labor & Capital**. They are combined to produce goods and services.

1. Who does the work?

A majority of us work, that is we produce the goods and services needed in our economy. We teach, we flip hamburgers, we repair cars, we work as check-out clerks, we manage corporations—all paid forms of work. Other jobs such as cooking, cleaning our homes and taking care of children are unpaid—all work nonetheless vital for the economy. However, this course, and most economics, limits itself to the study of paid work, although there is an important new field within economics that looks at how unpaid work is performed in the household.

Population in the United States is over **270 million people**:

About one half of the population is in the **paid labor force: 140 million people**.

- **75 million** are men & **65 million** are women
- **15 million** are self-employed & the rest work for someone else

2. Who owns the factors of production?

In our economic system there is almost always a division between those who work and those who own the tools, machines,

To economists:

Capital = man-made aids to production, such as tools, machines & factories

Land = Land and all natural resources used in production

Labor = all of the mental and physical work performed by people

factories, land, natural resources or what economists call the “factors of production.” A few people such as carpenters and doctors work independently with their own factors of production. But most of us work in an organization where we have no legal ownership of the tools, the buildings or the land. The owners of these factors of production typically are managers, stockholders, bankers, or other wealthy individuals. The distribution of ownership across society is an important topic of study in economics.

3. How are the basic economic decisions made about production and distribution?

Two answers are necessary to this question. On the level of individual companies, decisions are almost always made by a small group of people, such as presidents and vice-presidents, or sometimes stockholders. But in looking at the economy as a whole, there is another answer. The ultimate success or failure of economic decisions is determined by an impersonal **market** rather than by a single person or company. The outcomes of our economic system—prices and levels of output, for example—are not pre-planned, but are instead the result of a large number of individual decisions regulated by competition. Certainly there are exceptions to this generalization: companies advertise to influence the market; some companies dominate industries so that there is little actual competition; and parts of the economy (such as publicly-funded colleges and universities) are dominated by governments that do not compete in a private marketplace. But, generally, the marketplace is the most important way in which economic decisions are made in our economic system.

A Market:

is anywhere buyers and sellers come together to exchange goods and services, usually for money. It is the interaction of buyers and sellers in “markets” that determines prices and ultimately how much of each good that is produced.

4. What are peoples’ lives like?

This is the most difficult question to answer in a short space. In the U.S. we produce over \$8,000 billion (or \$8 trillion) worth of goods and services, the largest economy in the world. Our economy produces one of the highest yearly amounts of output per person (almost \$30,000 in production for each man, woman and child.) Of course, this output is not equally distributed. The most well-to-do 1 percent of the population takes in about 16 percent of all income, but owns about 40% of total household wealth in America. In historical

perspective, most citizens of the U.S. are extraordinarily well-off, compared to most individuals elsewhere in the world today. However, some countries can claim to have superior average standards of living for all their population because of more equal distribution of income and wealth and provision of decent health, child and retirement care to all citizens. Obviously this is a question that will require much further study in this course.

Ownership of Wealth in the U.S. (total value of existing assets: stocks, bonds, real estate, etc.)

- the richest 1% owns 39% of the wealth
- the richest 20% owns 85% of the wealth

Distribution of Family Income in the U.S. (yearly amount received in wages, salaries, dividends, etc.)

- the top 20% receives 55% of income
- the top 1% receives 16% of income

The U.S. Economic System

The economic system we have described for the U.S. needs a name. Most economists call it “capitalism;” sometimes it is called a “mixed economy.” In summary, our four economic questions for this capitalist or mixed economy are answered as follows:

- 1. Who does the work?** A majority of adults work for wages or salaries. A large number of adults also perform unpaid work in the home.
- 2. Who owns the factors of production?** Most of the tools, machines, factories, land, and raw materials are owned by a relatively small number of managers, stockholders, bankers, and other wealthy individuals.
- 3. How are decisions made about what is produced and how it is distributed?** At the level of the factory, office, or other workplace, decisions are made by a small group of owners or managers. In the overall economy, market competition determines prices, levels of output, and the success or failure of individual companies.
- 4. What are peoples' lives like?** Capitalism permitted the unleashing of unprecedented levels of material wealth. However, both wealth and income are unevenly distributed.

The Private sector:

refers to economic activities of **firms** and **households**, while

The Public sector:

refers to the economic activities of **government**.

A digression on capitalism, democracy and freedom

Sometimes the terms “capitalism,” “democracy,” and “freedom” are confused with one another. The U.S. has **economic**

Social sciences:

The academic disciplines of economics, political science, sociology, anthropology, philosophy, history and psychology that study the social behavior of human beings.

capitalism combined with **political democracy**. But the terms should not be used interchangeably.

Countries such as South Africa under the apartheid system and Hitler's Germany were capitalist systems, but neither was a democracy or enjoyed basic freedoms.

Other countries such as post-WWII

Sweden, the Netherlands, Australia, and Jamaica have democracy and freedom, and at the same time have elected socialist political parties to run the government. On the other hand, there are countries that call themselves socialist, such as China and Cuba, that do not have political democracy.

We shall return shortly to define socialism and communism. At this point, note that capitalism does **not** necessarily accompany democracy. And, socialism sometimes coexists with political democracy, while at other times it does not.

For the remainder of **Section I**, we will study economic history, going back many centuries to learn about the origins of today's capitalist and socialist economic systems. Then, in **Section II**, we will study the history of economic ideas, looking at the different ways in which economists have tried to understand economic systems.

Four Basic Economic Issues

- 1. Who does the work?**
- 2. Who owns the factors of production?**
- 3. How are economic decisions made?**
- 4. What are peoples' lives like?**

SECTION I: The Evolution of Economic Systems

Today's capitalist system has not always existed. In other words, the answers to our four basic questions on the previous page were quite different in the past. Consider the last question about peoples' lives. We all know past economies did not enjoy air-conditioning, computers, surf boards, or Coca-Cola. In previous years people did not have the advanced technologies to produce the goods and services we employ today. However, a visitor from past centuries coming to observe our society today would be shocked by the answers to the other questions as much as by our current goods and services. For example, anyone who lived prior to 1700 would be surprised that we buy and sell so many different items. For most of human history, people were self-sufficient for their food, clothing, and transportation, using money only for a few special items such as salt. Also, our visitor from the past would be surprised to learn that we obtain our current livelihoods by working for others and are paid a wage or salary. Again, until 300 years ago, most work was not based on the exchange of money. In order to understand these aspects of our economy that we take for granted—use of money for all purchases and working for pay—we need to go back in time to see how these developments came about. For convenience we will define four historical types of economic systems, or what economists call **“modes of production.”** For each of these modes of production our four basic questions are answered in quite different ways.

Modes of Production:

is a technical term for "economic systems"; each with a unique set of relationships between the producers of goods and the other groups in society. Karl Marx identified and studied **four historic "modes of production"**:

1. Primitive Communalism
2. Slavery
3. Feudalism
4. Capitalism

Primitive Communalism

For thousands of years prior to written history, humans lived in small tribal units. In order to improve the chances of survival, groupings of people worked collectively in their hunting and gathering economies. Although their tools appear 'primitive' to us, primarily spears, knives, bows, arrows, baskets, and pots, they produced sufficient necessities and often enjoyed considerable "free"

time. In many cases, economic decisions were made cooperatively for the good of the whole group, in some cases based on deference to a “chief” who distributed goods as needed, and in other cultures based on ritual exchange in which goods were distributed using traditions that maximized chances of survival of the group. Anthropologists specialize in the study of the fascinating variety in the way humans have chosen to organize themselves and arrange their material survival. Today primitive communalism survives only in a few very isolated regions of the world. Most of these groups have changed their mode of production, or they have been exterminated by more “advanced” groups.

Social Class

In almost all human societies individuals belong to groups that perform different roles and have higher and lower social status. In some societies such as slavery, social classes are unmistakable and obvious to all members of the society. In capitalist society, social classes are more complicated—some even argue that are no longer classes. However, the authors believe distinct social classes exist in our current society, including a small class that owns the factors of production, while a much larger class that works for these owners. Additional small classes either work for themselves or live on the edge of poverty without regular employment. As a result there are differences in wealth, income and power between individuals.

Slavery

Over time, better tools paved the way for primitive agriculture, which along with the domestication of goats allowed the nomadic tribes to settle in one place for longer periods and produce modest surpluses of goods. The evolution of

weapons and the technology of waging war led some primitive societies to form confederations and armies in order to conquer and enslave their neighbors. In this class society, the means of production (land and capital), as well as the slaves themselves were owned by slavemasters, who also made all of the economic decisions for society. Ancient Greek and Roman empires are examples of such slave societies in western history.

Surplus:

Production of basic goods and services beyond the amount required to meet the subsistence needs of a society, allowing for the accumulation of wealth.

In slave economies, we see the production for the first time of a “**surplus**”, that is goods beyond those needed to feed and clothe those who do the producing. Of course these surpluses did not belong to the slaves, but were kept by the slave-holding and freeman classes, who were freed from the drudgery of everyday labor. These leisure social classes engaged in intellectual endeavors that produced great advances in language, mathematics, science, art and literature, at the expense of the slave class that suffered great hardships and cruelties.

Slavery was found in early Middle East, African, Asia, Central and South American cultures. (Slavery in the southern United States during the 1700s and 1800s was a different system altogether because it was attached to a developing capitalist economy.) It is not often appreciated how much ancient civilizations relied on the slave mode of production; slaves built the Great Wall of China, mined the silver that supported Greek city-states, and millions of slaves constructed the monuments still standing in Rome and Egypt.

Aristocracy:

A class of individuals in which power is attained by birth. Feudal landlords were an aristocracy.

Feudalism

After the fall of the Roman Empire during the 300s, a new economic system slowly arose in Europe. By about 700 A.D., most of Europe had a **feudal** mode of production. From literature you may be familiar with the warriors of this period who were called knights. In terms of economic organization, the most important social class, at least in numbers, were called serfs, the majority of the population who worked the land. Unlike slaves, serfs could not be bought or sold; instead serfs and their offspring belonged to a feudal manor. (The system is also called "manoralism.") The ruler of the manor was called a lord, who had the authority over almost

By courtesy of University of Illinois at Urbana-Champaign Library



Punishing Serfs This seventeenth-century illustration from Olearius's famous *Travels to Moscovy* suggests what eastern serfdom really meant. The scene is set in eastern Poland. There, according to Olearius, a common command of the lord was, "Beat him till the skin falls from the flesh." (University of Illinois, Champaign)

Noted historian H.S. Bennett describes typical conflict within feudalism in his book *Life on the English Manor*:

Let us start with the village mill. We may safely assume that every village (and almost every manor) had one... These mills were either the property of the lord, or had been so at some earlier date, until he found his while to accept a yearly rent for them.

The will therefore became a valuable part of his income... Since the mill was of such financial importance it was necessary for the lord to see that its business was ample and that it was not threatened by rivals... Despite all manorial injunctions men were constantly failing to bring their corn to the lord's mill, and in due time found themselves accused in the Manor Court. Here they usually received short shrifts, and were fined, sometimes for grinding at another's mill, sometimes for grinding at home with a small hand-mill...

The greatest difficulty that faced the lord, however, was how to deal with the secret milling that went on in the peasant's own home... The lord tried to prevent this, and whenever possible fined those in possession of handmills.

Let us turn from these obligations of the mill...to other forms of oppression. As have already been noted, (the peasant) could not indulge in many of the most common actions without first obtaining the lord's leave, and this was usually given only as a result of a money payment. The fish in the rivers and the game in the woods were not at his disposal.

all affairs. He most often was an independent landholder who sometimes was a church bishop or a knight who was rewarded for his success. However the relationship between lord and serf usually followed tradition. The serf and his children could not be removed from the manor; the serf had access to the "common land" for firewood and hunting; and the lord received a sizable proportion, often nearly one-half, of the crops grown by the serf. In addition to aristocracy and serf classes, all feudal systems included other groups such as religious orders, monarchs, artisans (individuals who produce items for sale), and merchants (traders).

This form of traditional feudal agriculture spread throughout Europe between 600 A.D. and 1200 A.D., and continued in Eastern Europe until the 1800s. Economic systems similar to Europe's feudalism existed elsewhere, most notably in Asia,

where traditional relationships between landowners and agricultural workers persisted into this century.

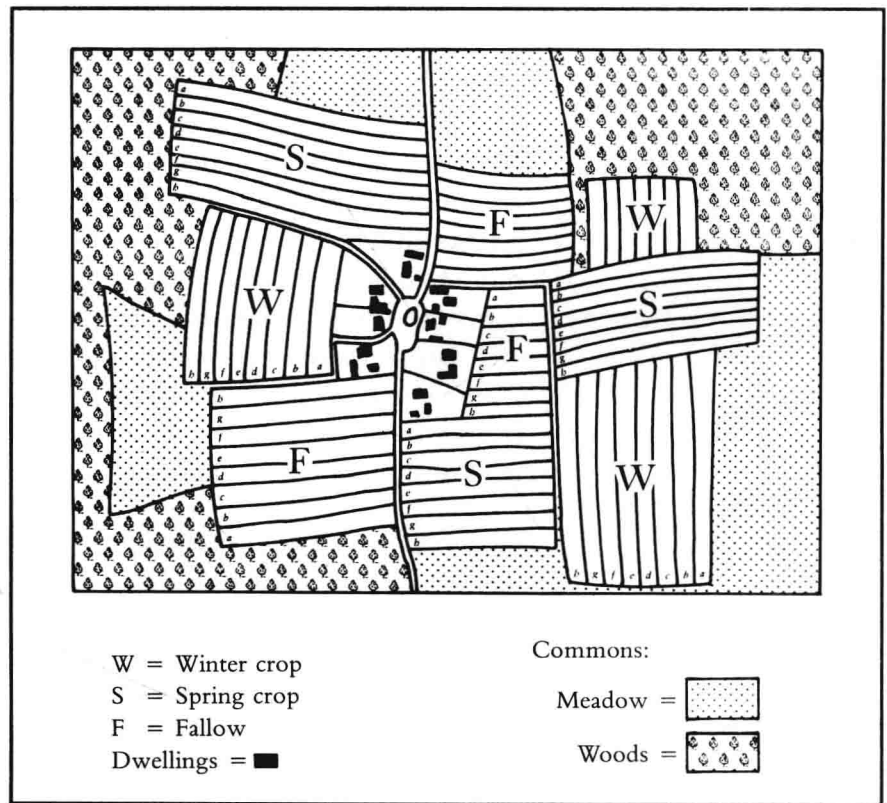
No observer of history would pick Europe in 1000 AD as the place in the world from which a new economic system called capitalism could ever evolve. In many ways Western Europe was far behind much of the world in its intellectual achievements, because it had not yet learned of important developments in Africa, the Middle East and Asia. Also its agricultural methods were quite primitive, relying primarily on human-force instead of animals, wooden, not iron plows, and little fundamental scientific knowledge such as crop rotation. Overall living standards were poor, both in comparison to much of the rest of the world, as well as by what we experience today. Therefore it was surprising that capitalism began

Discussion Question:
Where has feudalism survived in the modern world?

its development in Europe at this time.

Why Europe changed so quickly during the next few centuries is a much debated historical question. One theory is that precisely because Europe was so backward, no single monarch or ideology was able to control the entire region. As a result, a few independent towns emerged in what today are Italy, Germany, Belgium, and the Netherlands. In these towns, artisans and merchants could produce and trade without being subject to the control of monarchs.

(Whereas in monarchies controlled trade in most of the Middle East, China, and India, and Africa.) Thus, in relatively backward Europe, merchants initiated worldwide trade, bringing back knowledge as well as gold, silver, spices, and many other products. This widespread trade paved the way for the emerging capitalist system by improving the quality of roads and the reliability of axles, and by encouraging the development of new navigational and shipbuilding skills.



From M. Chambers, R. Grew, D. Herlihy, T. Rabb, I. Woloch, *The Western Experience* 5/e. Copyright © 1991, McGraw-Hill Inc., New York. pp 226, Reprinted with the permission of the publisher.

One reason peasants left the countryside is described by economist Robert Heilbroner in, *The Making of Economic Society*:

Starting as early as the thirteenth century, the landed aristocracy, increasingly squeezed for cash, began to view their estates not merely as the ancestral fiefs, but as potential sources of cash revenue. In order to raise larger cash crops, they therefore began to "enclose" the pasture which had been previously deemed "common land." Communal grazing fields, which had in fact always belonged to the lord despite their communal use, were now claimed for the exclusive benefit of the lord and turned into sheepwalks. Why sheepwalks? Because a rising demand for woollen cloth was making sheep-raising a highly profitable occupation.

The enclosure process in England proceeded at an irregular pace over the long centuries; not until the late eighteenth and early nineteenth centuries did it reach its engulfing climax. By its end, some ten million acres, nearly **half** the arable land of England, had been "enclosed."

Capitalism

Merchants

Individuals who make profits by buying and selling a product rather than producing it.

In retrospect we can see that new methods of production and new classes were being born during the late stages of European feudalism. But the process of developing today's capitalist economy was long and full of conflict. One key feature was a change in the traditional relationship between lord and serf. Beginning about 1000 A.D., lords more frequently rented their land to peasants rather than taking a portion of the crop from serfs. One reason was the rise of farming in Eastern Europe where there was a shortage of labor. A second reason was the increase in taxes that feudal manors were required to pay. The peasant farmworkers could now leave the manor, but were no longer guaranteed the tradition of passing farming rights to their children.

The increased demand for products led merchants to look for new ways of making items such as cloth for sale. The newly freed peasants became a major source of labor in the "putting out" system. Peasant families were loaned raw materials, often cotton and wool, and machinery such as spinning wheels and looms, to make finished products such as cloth. Later the merchant would return to purchase the final goods, which of course they sold for large profits.

Feudalism :

An economic system dominated by agriculture in which the most important economic relationships are determined by tradition. In Europe, where feudalism lasted from about 600 A.D. until 1800 (in Russia), the predominate form of organization was a manor controlled by a lord, on which serfs worked, giving part of their crop or work-time to the lord.

Mercantilism:

The economic system, based on trade between regions or nations, that introduced the capitalist era. (Approximately 1500 - 1700.) The traders attempted to maximize wealth for their nation by making certain that export sales were greater than import purchases and by making sure their nation always maintained the upper hand over their trading partners.

Capitalism

An economic system that arose first in Western Europe after about 1700, and now is the dominant economic system in the world. In a capitalist system most products are bought and sold with prices set by a market mechanism. The commodities bought and sold include the factors of production: capital, land, and labor. An individual's need to sell his or her ability to labor is unique to capitalism.

The putting-out system proved unsuccessful in part because there was no guarantee that the peasants would do the promised work—or even that the wool and loom would be there when the merchant returned. Also the putting-out system was too fragmented and unpredictable to meet the increased demand for processed goods. Consequently, merchants built the first factories, placing workers and machinery all under one roof, and the watchful eyes of the first supervisors. With the development of water power, mechanized equipment was introduced, greatly expanding the quantity of output and productivity per worker. By the 1700s, widespread use of factory production replaced many of the traditional artisan workshops. The majority of the population became city dwellers. Wage workers in factories replaced peasant farming

as the principle occupation, creating a large industrial working class and a much smaller capitalist, business-owning class. But this transition was a slow process, beginning during the 1700s in England, and not completed in most of the world until recent years.

Conditions in early factories are difficult for us to envision. The work was tedious; the hours were long—often 12 or 14 hours; the work week lasted six days; conditions were often harsh, cold, dirty, and unsafe; and typically entire families, including mothers and children worked side-by-side. Probably factory life can best understood from novels of this period by Zola and Dickens that portrayed the abject condition of working classes.

There were social classes other than factory workers and capitalists. In a few parts of the economy, artisans continued to make things and provide services on an individual basis, owning their own tools and selling directly to customers. In some countries such as Italy, the church was an important group, owning much wealth, producing goods, and providing an income for many individuals. In many countries, an aristocracy owned much land that was passed from one generation to the next through inheritance. In the U.S., independent farmers constituted a large group that did not exist in other countries.

Over time, all of these other social classes—artisans, church leaders and aristocrats—became less powerful than the capitalist class. Ownership of the means of production proved more important for economic power than ownership of land or labor power. Those who worked became concentrated in a single class of wage and salary workers, while fewer people worked independently as artisans or farmers. Today, artisans and farmers, constitute less than 10 percent of the U.S. workforce, leaving the capitalist class and working class as the two largest classes.

Economic systems today

The widespread buying and selling of things in what economists call “markets” dominates the capitalist mode of production. Nonetheless there are other non-market economic relationships that each of us encounters every day. For example, in your family there are relationships similar to primitive communalism. Jobs are done—the children are cared for—and resources are allocated—food is taken out of the cupboard—on the basis of individual need and individual ability to provide. In Figure 1 (page 13) the three corners of the triangle

Discussion Question:
Where does a system similar to "putting-out" still exist?

Market: An economic system in which goods and services are allocated by prices that fluctuate depending upon supply and demand.

Command: An economic system in which goods and services are allocated though decisions made by a central authority, such as slave-masters, feudal lords, or government planners.

Cooperative: An economic system in which goods and services are produced and distributed based on individual abilities and needs. Such practices were common in Native American tribes, and perhaps occur in your religious or social groups.

represent the relative use different economic relationships in today's economy. We place family relations in the corner marked "cooperation"—but not quite in the corner. In most families decisions about who does the work and who receives the resources are not shared equally as in a totally cooperative relationship. If one person or group of people makes the decisions, then the economy has a command orientation. Finally, there is a third option: in some families there is also a market system, perhaps when an adult family member pays rent.

Probably the best-known visionary of future societies was Karl Marx, an economist who we will study in depth shortly. Marx described a possible future communist form of society that would combine the cooperation and fairness of primitive communalism with the advanced productivity of a capitalist economy. In other words, **communism, for Marx, was a distant goal** in which the economy would provide "from each according to his ability, to each according to his needs." After analyzing the four historic modes of production Marx speculated that capitalism would first be replaced by **socialism**, and much later socialism would be replaced by communism. In simple terms Marx envisioned these systems as follows:

Marxian Socialism:

An economic system with public ownership of the factors of production and state control of economic decision-making, with wages paid according to work done.

Communism:

A society in which production and human nature are so highly developed that there are no longer social classes. Government and the market are no longer needed because decisions about production and distribution are based on people's needs and desires.

Other examples of cooperative economic relationships in your life may include your religious or social groups in which everyone shares responsibility for work. The best example of a command economic relationship in a modern economy is a typical job in which the employer tells the employee when to come to work and what to do when he or she arrives. As the example of a market in the triangle we use a yard sale because in this case the buyer and seller come face-to-face to determine the price of the product depending on supply and demand. But you also take part in a market when you buy gas for your car, although in this case your purchase is such a tiny fraction of the total demand that you can't see its effect on price. Thus we have everyday experiences with market, command and cooperative relationships.

In Figure 2 (page 13), we place the economic modes of production we have studied thus far in the command-market-cooperation triangle. Slavery is primarily a command relationship between slave and master. Primitive communalism lies in the cooperation corner, but not quite in the corner because there were some command relationships, for example tribal leaders. Also some primitive communal groups engaged in market-like trading with other groups. Feudalism was a command relationship between lord and serf, but not entirely in the command corner because, as we have seen, there were cooperative relationships among artisans in guilds. Also, recall

that under feudalism a few isolated Western European cities, a small merchant class that bought and sold products in markets.

Finally, in Figure 3 (page 13) three we place modern countries in the triangle according to how much of each characteristic they possess. No country relies entirely on the market; we place Hong Kong closest to

the corner because so much of the economy takes place in the market with little government involvement. The United States is slightly distant from the market corner because various levels of governments produce and allocate many goods and services, totalling about one-third of the economy. These products include the military, roads, most education and many other services that are paid for by taxes and allocated on the basis of need rather than by a price system. Because U.S. governments are democratic in principle, we place the U.S. slightly toward the cooperative corner.

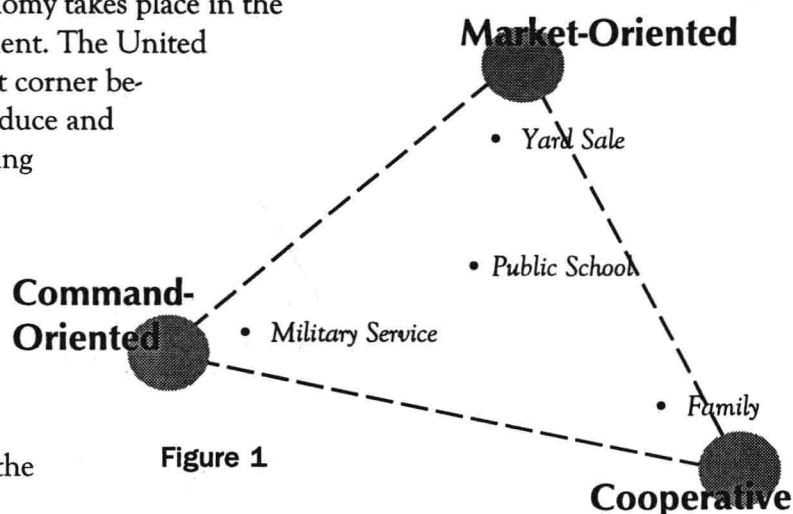


Figure 1

European countries are placed closer to the cooperative corner because they offer a broader array of government services than those available in the U.S. In Sweden, for example, there is publicly-provided health care, day care, financial stipends for all college students, sizeable pensions for all retirees, and time-off with pay for new parents. Economic systems such as Sweden that provide a comprehensive set of social services generally are called "welfare socialism."

A second variation on the market economy is government ownership of selected industries. For example, in Mexico, the oil industry has been owned by the government and in Germany, the railroad system and telephone company are government-owned and operated. When there is a large degree of such government ownership, while most industries are privately-owned, the country is placed toward the center of the triangle.

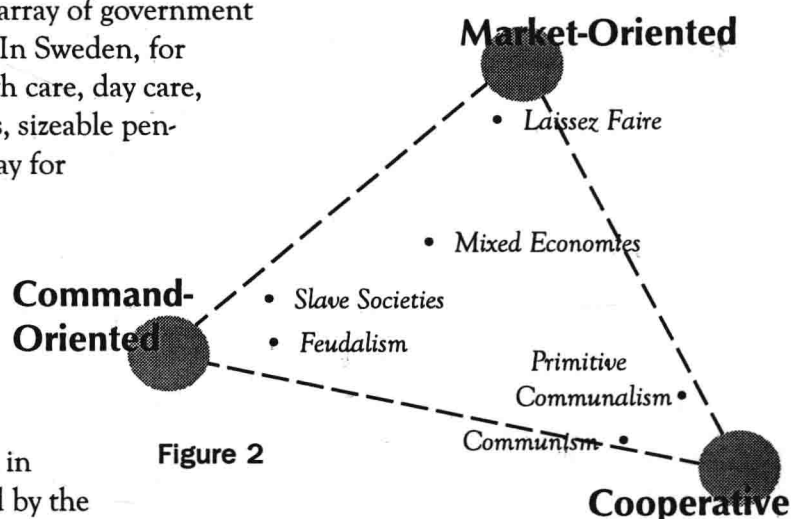


Figure 2

Japan, South Korea, and other newly-industrialized Asian countries are primarily market economies because most businesses are privately owned. But government is involved in helping businesses to coordinate their plans. For example, several years ago Korean government leaders, in consultation with business leaders, decided that automobile production and computer assembly would be the major exports. Laws were passed that guaranteed special treatment such as low interest loans, to businesses who would help the country export cars and computers. We put

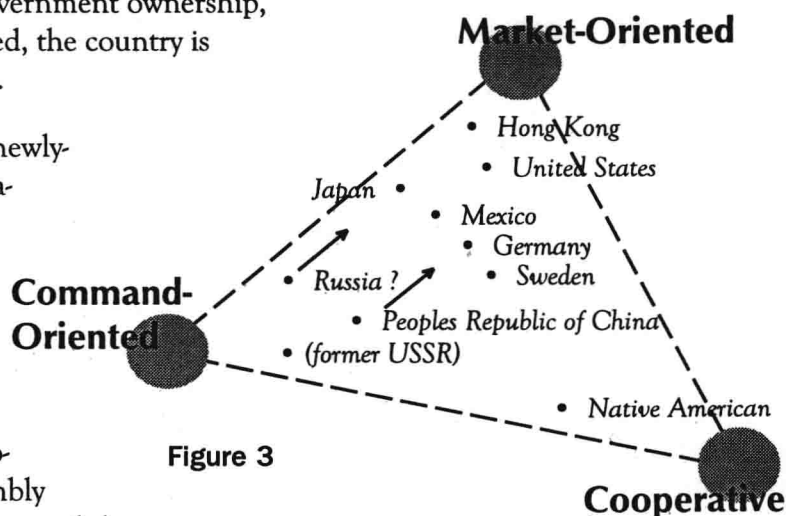


Figure 3