ESSENTIAL QUESTION

How does an economic system help a society deal with the fundamental problem of scarcity?

Academic Vocabulary

undertaking  beginning an activity
isolationism national policy of avoiding international alliances and economic interactions

Content Vocabulary

GDP per capita gross domestic product on a per person basis; can be expressed in current or constant dollars
privatization conversion of state-owned factories and other property to private ownership
voucher certificate that could be used to buy government-owned property during privatization
Five-Year Plan comprehensive, centralized economic plan used by the Soviet Union and China to coordinate development of agriculture and industry
Gosplan central planning authority in the former Soviet Union that created and devised Five-Year Plans
collectivization forced common ownership of factors of production; used in the former Soviet Union in agriculture and manufacturing
perestroika fundamental restructuring of the Soviet economy; policy introduced by Gorbachev
Great Leap Forward China’s second Five-Year Plan, begun in 1958, which forced collectivization of agriculture and rapid industrialization
nationalization shift of an economy, or part of an economy, from private ownership to government ownership
Solidarity independent Polish labor union founded in 1980 by Lech Walesa
European Union successor of the European Coal and Steel Community established in 1993 by the Maastricht Treaty
black market market in which goods and services are sold illegally
capital-intensive requiring relatively large amounts of capital relative to labor
keiretsu independently owned group of Japanese firms joined and governed by an external board of directors in order to regulate competition
population density number of people per square mile of land area
The biggest economic trend of our lifetime has been the shift of communist and socialist economic systems to capitalism. It has been a massive change, and it shows few signs of slowing down. As countries transition, the final form of capitalism they take will reflect their values. That is one reason why there are so many different types of capitalism in the world today.

Some countries have almost finished their switch to capitalism. These include Chile, Russia, and the former Soviet countries of Eastern Europe. But their GDP per capita, or GDP per person, is still lower than those in other capitalist countries because they formally had command or socialist economies.

### Problems of Transition

**Guiding Question:** *In what ways does the mind-set of a country’s citizens have to change in order to transition to capitalism?*

*When an economy becomes large and complex, a capitalist market-based system is the most efficient way to organize production and provide the necessary economic incentives. But economies that are not capitalist often have a hard time switching over.*

**Why Capitalism?**

*Simply put, capitalism is the most powerful engine for making wealth in the world. Because of capitalism, places that are very different culturally have greatly increased their productivity. They include Germany, Japan, Singapore, South Korea, Sweden, the United States, and Hong Kong—countries that have enjoyed remarkable economic growth.*

This growth has improved nearly everyone’s standard of living, allowing people to obtain both necessities and luxuries that make life easier.
The world is becoming more and more connected by the media, which makes people everywhere aware of the wealth that capitalism can generate.

In contrast, the collapse of the Soviet Union shows that communism as an economic system has reached a dead end. Pure capitalism can be harsh and may not be attractive to everyone. But in democratic nations, people can adjust capitalism to meet more of their economic and social goals.

There is no guarantee that countries trying to change to capitalism will be able to do it smoothly, or that they can do it at all. This is because there are so many challenges to overcome.

Privatization of State-Owned Property

A key part of capitalism is owning private property. In order to switch to capitalism, *privatization*, or the change of state-owned factories and other property to private ownership, must take place. Privatization is important because entrepreneurs want to be rewarded for *undertaking* business projects with risk. Private property is also important because people take better care of property they actually own.

In Poland, Hungary, and the Czech Republic, this change was done by using *vouchers*, certificates that people could use to buy government-owned property. The government gave vouchers to its citizens or sold them at very low prices. State-owned companies could then become corporations, and the corporations could sell its stock for vouchers. As people traded vouchers for certificates of ownership, the ownership of state-owned enterprises transferred to private hands.

Loss of Political Power

*Under communism, the Communist Party was the ruling class. When countries switched to capitalism, the party feared that it would lose much of its political power to the new class of entrepreneurs and capitalists.*

In countries such as Czechoslovakia, Hungary, and Poland, the Communist Party leaders were kicked out of office before their country’s industry was privatized. In these countries, the voucher system worked fairly well to redistribute wealth to new leaders.

In other countries, Communist leaders grabbed a large share of vouchers and thus a large part of ownership in many privatized companies. In the most obvious cases, the government gave ownership of companies directly to politicians who were important during the transition period. Some of this happened in Russia after the collapse of the Soviet Union.

As a result, former political leaders traded their political power for economic power through owning resources. So the old ruling group simply became the new ruling group. In Russia, the members of the old ruling party had a difficult time actually giving up their power.

Responding to New Incentives

*People in countries that switch to capitalism have to adjust to a whole new set of rules. They must learn how to make new kinds of decisions, take initiative, understand prices, and be on their own in free markets. Many of these changes are huge, often even too huge.*

For example, some workers were used to getting the same pay regardless of how hard they worked or how often they came to work. Now they must adjust to the risk that they will get fired if they do a poor job. Factory managers have to learn to repay bank loans and pay their bills, and do it on time.

Underestimating the Costs

*Too many countries want the advantages of capitalism without fully considering its costs. Yet the costs can slow or even stop a country’s successful transition.*
Chapter 2: Economic Systems and Decision Making

Lesson 3  The Global Transition to Capitalism, *Continued*

The costs of capitalism during the Great Depression, for example, included instability, unemployment, and social unrest. At that time, the United States did not have the economic policies and social welfare programs needed to lessen the damage. Now that such help exists in the United States, most economists agree that another Great Depression will not happen here.

This is not true for the countries in transition. They have not yet developed the automatic supports and the social welfare nets that cushion the instabilities of capitalism. During transition, countries will experience the instabilities of early capitalism long before they experience the benefits.

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**Countries and Regions in Transition**

**Guiding Question:** *What are the common features of the transition to capitalism?*

*Despite the difficulties, most nations and regions all over the globe are moving toward capitalism. Some have a little further to go than others, but may eventually get there. Others seem to have gone about as far as they ever will go.*

**Russia**

*To see why the transition to capitalism has been so difficult for Russia, it helps to understand how the economy was managed during the Soviet era. During that time, the government controlled economic activity with Five-Year Plans. A Five-Year Plan was a complete, centralized economic plan designed to reach industrialization fast. Joseph Stalin introduced the first Five-Year Plan in 1927.*

The Gosplan was the central authority that made the plans and directed general economic activity. Collectivization, the forced common ownership of all agricultural and industrial enterprises, allowed the Gosplan to run the economy. It assigned production quotas to all Soviet industries, including farms. Planners tried to make sure the growth of the economy simply by increasing the quotas.

Central planning ultimately failed. The Soviet economy had become too complex and large to be managed by a single planning bureaucracy, or administrative group. Shortages appeared everywhere, workers were often unpaid, and many people lacked reasons to work.

After Mikhail Gorbachev came to power in 1985, he introduced perestroika, the restructuring of the Soviet economy. Under Gorbachev, plant managers had more freedom to pursue profits, and small business was encouraged.

Russian president Boris Yeltsin came to power after Gorbachev. He sped up privatization after the fall of the Soviet Union. The government gave out vouchers to citizens so that they could buy ownership shares in companies being privatized. Eventually Russia opened a stock market. Individuals could own stocks in a country that once said private property was evil.
Under the first regime, or rule, of President Vladimir Putin, privatization began to slow. Putin used his power to take back centralized control of key energy and mineral industries. He did this by claiming to fight corruption. The period of transition to capitalism is now over for Russia. Under the second presidency of Putin, the country has a market-based economy except for energy, natural resources, and defense-related industries, which the government controls.

**China**

The People’s Republic of China became a communist economy in 1949. That year the Chinese Communist Party, under the leadership of Mao Zedong, gained control of the country. Over the next few decades, China copied the Soviet Union, adopting a series of Five-Year Plans to manage its growth. In 1958 Chinese leaders began the Great Leap Forward. This was an attempt to transform industrial and agricultural production almost overnight. This ambitious and radical Five-Year Plan forced farmers off their land to live and work on large, state-owned communal farms.

The Great Leap Forward was a disaster. The agricultural experiment failed. The economy never came close to reaching the planned level of industrialization. Other plans followed, but by the late 1970s China finally decided to give up on the Soviet example.

By the early 1980s, the influence of other successful market economies in Asia—especially in Hong Kong—was too much for China to ignore. Guangdong Province, one of China’s provinces just north of Hong Kong, copied many of the free market practices of the region. China even allowed it to officially experiment with capitalism.

Today China is privatizing some industries, introducing market reforms, and otherwise acting in a capitalistic way. The progress made so far is remarkable. Now it is the world’s second-largest economy. China’s transition was possible because it was willing to replace communist beliefs and control with capitalistic practices.

China’s transition to capitalism is not yet complete. It still has a long way to go, but it has made the reforms at a slow, steady rate. Its government still controls many prices and still owns many industries, although many state-owned firms have been given more independence.

At the same time, China faces some problems that may slow its growth. The population is getting older, and eventually the country will lack younger workers. Pollution of the air and water is another major problem. It was so bad that China had to take extreme steps to reduce air pollution during the Beijing Olympic Games in 2008. To reduce air pollution, the government banned approximately 300,000 heavy trucks during the Olympics. It also only allowed half of the city’s 3.5 million vehicles to drive every other day. Plus, in 2013, over 13,000 dead and decaying pigs floated down a major river that flowed into Shanghai. Even though the river supplies the city with about one-fifth of its water supply, government officials said the water quality was “normal.”

**Exploring the Essential Question**

*Imagine that you are an industrial worker in a city in China. What would you put in an e-mail to a relative in the United States explaining how China’s transition to capitalism is affecting your work and your daily life?*
Latin America

In the past, many Latin American countries followed a path of economic development that combined socialism and isolationism. But Chile took major steps to encourage the growth of capitalism when it privatized airlines, telephone services, and utilities. The country even used the billions in its pension, or retirement, funds to give capital to new entrepreneurs. As a result, it now exports copper, paper and pulp, fruit, and chemicals.

Today Chile has one of the strongest market-oriented economies in the region. It is very involved in foreign trade and has developed strong financial institutions. The conversion to a free market economy is now complete and has been a definite success.

In a similar way, Argentina has begun a program to remove government from the everyday business of running the economy. The country is rich in natural resources. It also has a highly literate population and a diversified industrial base. At first the government sold state-owned oil fields, petrochemical plants, and a number of other businesses to private companies. Since 2000 it has experienced both high rates of growth and a major crisis in its banking systems. But political instability and the nationalization of several major energy companies has stopped the full transition to capitalism. Nationalization is the shifting of private property to government ownership.

Finally, one country clearly resisting the transition to capitalism is Venezuela. President Hugo Chavez ruled as Venezuela’s president until his death in March 2013. Chavez turned the economy into a socialist state. There was a housing crisis, rapidly rising prices, and not enough electricity and food. Venezuela’s new president has promised to continue the socialist policies, but the private sector is in chaos. It is uncertain if the trend toward socialist policies will continue.

Eastern Europe

The nations of Eastern Europe, especially those that were unwilling members of the former Soviet bloc, or group of countries, were eager to be rid of communism and embrace capitalism.

The struggle for freedom began in Poland with Solidarity, the independent and sometimes illegal labor union begun in 1980. Solidarity was effective in getting a number of political freedoms in Poland. Eventually, the Communist Party lost power, and interest in capitalism grew. In 2004 Poland joined the European Union (EU), the organization of European nations created in 1993 to develop a single market with full economic and political cooperation.

Hungary also made a successful transition to a market economy. It was already the most “Western” Communist bloc country, with a successful black market, in which entrepreneurs and merchants sold goods illegally. That experience with markets helped ease the transition, and Hungary became a full member of the European Union in 2004.

Finally, in 2004 the EU accepted the Czech and Slovak Republics, along with Estonia, Latvia, Lithuania, and Slovenia. These countries, along with Bulgaria and Romania, which joined in 2007, made great steps toward capitalism after the fall of the Soviet Union. All of these countries completed one of the more remarkable transitions of economic systems in history, moving from communism to capitalism in a fairly short period of time.
Other Faces of Capitalism

Guiding Question: Why is capitalism different in different countries?

Some former socialist or communist countries are still making the transition to capitalism. Many other countries have had successful capitalist economic societies for some time. This is one reason that so many other countries are trying to make the transition. As Figure 2.3 shows, capitalistic countries have much higher per capita incomes than other countries.

Japan

Japan, like the United States, has a capitalist economy based on markets, prices, and the private ownership of capital. There are several reasons for Japan’s success. One is that Japan has a loyal and dedicated workforce. At many companies, employees arrive early for work to take part in group exercise and meditation to make their day more productive.

Another reason is the ability and willingness of the Japanese to develop new technologies. Because of its small and aging population, Japan has worked to improve productivity by developing methods that are capital-intensive, instead of labor-intensive. Capital-intensive industries use large amounts of capital for every employee. Japan is a world leader in developing industrial robots.

What really sets Japan apart from the United States is how much Japan’s government is involved in the day-to-day activities of the private sector. The country’s Ministry of International Trade and Industry (MITI), for example, is a government body that finds promising export markets. The ministry then gives subsidies to industries to make them competitive in those areas. A subsidy is money the government gives to help a business or lower a price.

The world looked to Japan as the perfect example of growth in the 1980s. But beginning in the 1990s, Japan has experienced economic stagnation. Part of the reason is that most large Japanese firms belong to a keiretsu (kay · reht · soo). This is a close group of firms run by an outside board of directors. The role of the keiretsu is to make sure that competition does not threaten individual firms. A similar agreement in the United States among competing firms would be illegal under our antitrust laws.

Modest economic growth returned in 2003 and continued until 2008, when Japan entered the global economic slump of 2008–2009. Before it could fully recover, in 2011 a huge tsunami hit Japan. The tsunami destroyed a major nuclear reactor and took nearly 20,000 lives. Since then, public opinion turned against nuclear power. The government shut down almost all of its 50 nuclear reactors two years later.
South Korea

One of the most successful nations in Asia is South Korea. After it was separated from North Korea in the mid-1950s, South Korea was one of the poorest countries in Asia. It needed to rebuild an economy torn up by war. The country also had the highest population density—number of people per square mile of land area—in the world.

The South Korean government began by opening its markets to world trade. At first, the government focused on only a few industries. This let its people get experience producing and exporting for world markets. Businesses in South Korea began to produce low-cost toys and consumer goods. As they became skilled in production and exports, businesses next moved into textiles such as shirts, dresses, and sweaters. They then invested in heavy industry, such as shipbuilding and steel manufacturing.

Today, South Korea is a major producer of consumer and electronic goods such as home appliances and televisions. The country also has become a leading producer of automobiles. The South Korean experience shows that capitalism can change a badly war-damaged economy into a well-developed, highly industrial one in just a few generations.

South Korea, like other nations of the capitalist world, recovered slowly from the worldwide recession in 2008–2009. But it shows no signs of changing its commitment to capitalism. Its major industries are in the export sector. This means its recovery and future economic growth are closely tied to the continued recovery of other capitalist systems in the world.

Singapore

Singapore is a small island nation about 3.5 times larger than Washington, D.C. It has a per capita income higher than most other developed nations. The attraction of generous tax breaks, government subsidies, and government-sponsored training of employees has drawn thousands of global firms to Singapore. Singapore developed its own technologies through spending on research and development, which played a major part in its strong economic growth.

The government of Singapore has focused on a few select industries. These include telecommunications services, software, and biotechnology. The government has spent millions on laboratories. This has attracted top scientists from all over the world. Medicines and medical technology are now leading industries. Singapore is Southeast Asia’s leading financial and high-tech center.

The high rates of recent economic growth, its corruption-free environment, and its solid capitalistic structure are all reasons for Singapore’s remarkable performance.

Taiwan

Taiwan, formerly known as Formosa, is an island off the coast of the much larger People’s Republic of China. The population of Taiwan is about 23 million, and the per capita income is almost 80 percent of that of the United States.

Planning has always been a feature of the Taiwanese economy. The government tries to identify those industries most likely to grow in the future. Most of these plans target high-tech industries such as telecommunications, consumer electronics, semiconductors, precision machinery, aerospace, and pharmaceuticals. Government direction of investment and foreign trade is lessening. The country has also signed a number of international trade agreements with capitalistic nations, which should help boost growth.
Taiwan was one of the early economic powers in Asia. But some experts have warned that the centralized planning process will hold back future economic growth. Another concern is the looming presence of the People’s Republic of China. China sees Taiwan as a “renegade province” and promises final unification. Despite its early start, the per capita GDP in Taiwan has fallen behind those of Hong Kong and Singapore.

**Sweden**

*Swedish is now a mature industrial nation.*

The Swedish economy was once thought to be the perfect example of European socialism because of its generous maternity, education, disability, and old-age benefits. Social benefits were expensive, however. To pay for them, the highest tax ranges reached 80 percent. This meant that a person who earned an additional $100 would keep only $20. Many athletes and celebrities left the country to avoid high taxes.

Eventually the heavy tax burden, the high costs of the welfare state, and huge government shortfalls cut into Sweden’s economic growth and led to the defeat of the Socialist Party. After a new government committed to a free market economy, it lowered taxes, and privatized many government-owned businesses.

Today Sweden has a mix of high-tech capitalism and generous benefits. The welfare system attracts other residents of the EU, and contributes to a relatively high unemployment rate. Despite the taxes required to support the welfare system, Sweden still puts out a relatively high GDP per capita.

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### Reading Progress Check

**Explaining** How did Japan, Singapore, and South Korea manage to become some of the more successful economies of the late twentieth century?

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