


Introduction to Political Economy



BY

**Charles Sackrey, Geoffrey Schneider,
and Janet Knoedler**

EIGHTH EDITION



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Eighth Edition

Charles Sackey, Geoffrey Schneider,
and Janet Knoedler

with contributions by Hans Jensen

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Preface to the Eighth Edition

We have written this book to introduce our readers to what we are calling “political economy.” We want to distinguish this kind of economics from the “mainstream” of economics that dominates instruction in contemporary capitalist societies. If you are taking an economics course at almost any U.S. university or college, your teacher has almost certainly assigned you a textbook from what we call the economic mainstream. In the most general terms, how are these two traditions, political economy and mainstream economics, different from each other? We can begin an answer with a passage from one of the very few contemporary textbooks that gives attention to them both.

Political economy...is more concerned [than mainstream economics] with the relationships of the economic system and its institutions to the rest of society and social development. It is sensitive to the influence of non-economic factors such as political and social institutions, morality, and ideology in determining economic events. It thus has a *much broader focus* than [mainstream] economics. (Riddell, Shackelford, Stamos, and Schneider, 2009, emphasis added)

A bit of historical background will help to make sense of this quotation. What we are calling political economy was first fully developed in the work of Adam Smith, whose 1776 book, the *Wealth of Nations*, contained a fabulously rich combination of theoretical analysis, historical setting, and copious detail. Smith took into account anything and everything that caught his attention, and to read the *Wealth of Nations* is to discover the broad outlines, and countless details, of British life in the late 18th century. For most of the 19th century, people studying the economy, the most prominent of whom were Karl Marx and Thorstein Veblen, followed Smith's lead. They produced broadly cast arguments in which there were no predictable boundaries lim-

iting the kinds of “economic” knowledge taken into account. While Marx, Veblen, and other such political economists clearly focused attention on economic activity—how people produced their livelihood and how they divided it up—they roamed far and wide in looking for ideas and information that would help them to explain what they saw.

However, after the middle of the 19th century, more and more social scientists adopted a version of the “scientific method,” borrowed from physical scientists such as physicists, chemists, and biologists. Successes in these scientific fields starting in the 16th century had enticed social theorists into taking a scientific approach to their studies, and this was certainly true of economists. By the 20th century, and especially after 1950, economics increasingly came to be expressed in the terms of mathematics and statistics. Presently, the economics profession is dominated, as are the graduate schools that produce professional economists, by economists who exclude from their analyses most of those things that are not readily measurable or appropriate for quantitative model building.

As the discipline has been narrowed, it has pushed to the margin alternative schools of economics, especially political economy. Political economists, as defined above by Riddell, Shackelford, Stamos, and Schneider, have gradually found their work shunned by the major economics journals, often because it is considered to be “non-economic.” From our view, the most unfortunate consequence of this trend is that the ideas of writers like Marx and Veblen, and others who extended their work, are rarely studied by economists as graduate students. Correspondingly, these important ideas are less frequently taught by such graduate students when they become professors.

We have written this book to try to bridge this gap. In this eighth edition, we have once again updated much of the book in order to take account of key economic events in the world during the two years that have passed since the previous edition. We have updated data and examples throughout the book to demonstrate the continuing relevance and importance of political economy to the modern world. We have also added new information boxes to chapters that broaden the content in key areas to help demonstrate the vast scope of political economic analysis. These additions include features on the role of government; inequality and its connection with race, gender and class; how Finland establishes traffic fines based on income; the promising “Cleveland Model” of creating cooperatives and jobs utilizing local anchor employers; and much more.

In our initial chapter, we provide our readers a more detailed look at political economy by comparing its essential ideas and concepts to those of the economic mainstream. We follow this first chapter with three on the central writers in the political economy tradition, Smith, Marx, and Veblen, whose

ideas, as we shall see, provide the structural frame for the rest of the book. In Chapter 5, we take up the ideas of John Maynard Keynes, whose work in the 1930s on the booms and busts of modern capitalist societies revolutionized the way economists understand capitalism and the measures necessary to keep it from collapsing. Keynes, who actually straddled the fence between political economy and mainstream theorizing, shared with political economists the practice of casting an exceedingly broad net for useful facts and ideas in his work. Though he had little use for Marx's writings, he often indirectly legitimated political economy by using his grand and eloquent voice to criticize mainstream economists for the narrowness of their studies.

We follow the first five chapters, ones that focus mostly on systems of thought, with five that analyze the impact of these ideas on our own world. In Chapter 6 we describe and analyze social classes in U.S. capitalism, in part because they are a central aspect of all political economy analyses of capitalism. We also discuss social classes because they are crucial to how capitalism shapes our lives, and, as we shall see, because they are virtually ignored by mainstream economics. We then turn in Chapter 7 to the theory of "social balance," developed by John Kenneth Galbraith to describe how corporations cajole and bamboozle us into buying goods and services we don't need, while environmental pollution spreads wider and deeper, and the public sector—the infrastructure—is in a continuing decline. Chapter 8 shows how Marx's ideas were extended to current times in the theory of "monopoly capital" advanced in the 1960s by Paul Baran and Paul Sweezy. These two economists used Marx's key idea of "surplus value" to try to understand what they ultimately called "the irrational system" of U.S. capitalism. Following Chapter 8, we have added a vignette on the sometimes questionable behavior of large corporations, and what these corporate misdeeds tell us about the corporate structure and its role in the economy.

In Chapter 9 we describe the modern welfare state in Sweden, which has been shaped by political economists in that country for over a century. To study the Swedish economy is to catch a glimpse of life in a society where the public understanding of capitalism, how it works, and how it should work, has been influenced more by ideas from political economy than by those from the economic mainstream. In the final chapter, we discuss another exemplary case study of these ideas put into action in the form of the Mondragón Cooperative Corporation, the world's largest conglomeration of cooperative-run businesses, located in Spain's Basque Country. Mondragón is notable for several things, most especially that it is a huge and expanding global firm owned completely by its workers, and for its commitment to maintaining an alternative economic model in the age of globalized capitalism.

The sequence of chapters we have chosen here has proven helpful to us in teaching the book to undergraduates, yet we suggest that others use the sequence that makes the most sense for their own courses. In order to encourage readers to go through the book in various kinds of ways, we have written each chapter to work mostly independently of the others. A consequence of this independence is that our readers will find some repetition as they go along. However, we have tried to limit this repetition to information or concepts that can bear a second going over. If our readers are assigned this book alongside a typical mainstream textbook, they can judge for themselves which approach, or which combination of approaches, works best to help them understand the economic world in which most will spend a lifetime trying to make a living.

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Finally, we want to extend our appreciation to the editors at *Dollars & Sense*, the publishers of the book. Alejandro Reuss and Chris Sturr provided valuable comments on this and previous editions. Alejandro and Chris are also political economists, and in countless ways they helped us better to express what we were trying to say. They are knowledgeable and straightforward enough on several occasions to let us know where our interpretations of historical events, or of the ideas we were describing, were either wrong or misleading. No writer could ask for better help from an editor. Thanks, Alejandro and Chris!

The Political Economy Challenge to Mainstream Economics

Discussions of contemporary capitalism have long been dominated by one line of thinking, which we will define below as the “mainstream” of economics. This mainstream has either ignored, or labored to discount, alternative ways of thinking about the economy, such as those that we described in our preface and that fill up this book. A major consequence of the mainstream refusal to take up alternative ways of seeing the economy is that most students taking economics courses in the United States today will not hear about them. We hope that this chapter will provide a good argument for our readers to push ahead to see what mainstream economists have been hiding from them.

WHAT IS MAINSTREAM ECONOMICS?

Like all areas of social inquiry the mainstream school of economics constitutes a broad spectrum of often-conflicting ideas. Thus, when we refer to “mainstream economists,” we are necessarily lumping them into a single category that is an obvious distortion, much like that of any such categorization. Our critique in this chapter refers mostly—but not exclusively—to economic models that (1) are narrowly conceived, (2) are quantitative and expressed in complicated inathematical terms, and (3) depend upon certain restrictive assumptions about how people behave, always have behaved, and always will behave. Without question, there are mainstream economists who engage in lively debates on virtually all of the topics we take up in this chapter. Many of them move beyond the strict confines of models and assumptions to examine institutional aspects of the economy. And many em-

pirically investigate people's actual behavior, instead of assuming that they all behave in the same, predictable way.

Why, then, do we focus on those mainstream economists who most narrowly conceive the subject? There are two parts to our answer. The first is that this subset of economists dominates contemporary economics and exercises its dominance through its almost exclusive control over graduate training in economics and the most prestigious economics journals. It is also the subset that has produced all but a few of the Nobel Prize winners in economics. The second reason for our focus is that, of all schools of economic thought we know about, this one is *least* likely to produce results useful to the public. Therefore, a genuinely interesting irony underlies what we write about in this chapter: the very "best" economists, in the view of this dominating subset, produce some of the least useful kinds of economics. We recognize that this is a substantial conclusion, and we hope that reading this and the following chapters will lead our readers to consider it at least as reasonable.

A central part of our argument is that there is a critical distinction between *all* versions of mainstream economics and what we call political economy. This distinction is a matter of methodology, or "method of analysis." Mainstream economists are trained to limit the scope of their analyses—that is to limit the breadth of knowledge they bring to bear on an issue—much more than so than do political economists. In choosing a relatively narrow focus, almost all mainstream economists have gradually and systematically excluded from their studies the political economy point of view. The political economy critique presented here is both a general critique of the mainstream methodology, and a more specific critique of the subset of mainstream economics that is most narrow in its approach.

THE DIFFERENCE BETWEEN THE MAINSTREAM AND ALTERNATIVES

Let's consider the following example that demonstrates the wide chasm between mainstream economics and Marxist economics, a principal kind of political economy. How does each view the production of business profits in capitalism? A mainstream economist might put it like this:

Profits are the payoff to private individuals for "entrepreneurship," for having saved, or borrowed, funds to invest in productive inputs, for having the foresight to know what goods or services to produce with these inputs and the talent to manage how the inputs are used and the goods marketed. Profit-making is the central vehicle by which capitalism is energized because: (1) by investing the funds, producing the goods, and making the profits, the enterprising capi-

talist gives jobs to people who are not capitalists themselves and who need those jobs in order to live; (2) the capitalist will make the highest profits only by producing goods and services most demanded by consumers; and (3) it is the competitive quest for profits that gives capitalism its extraordinary dynamism and proven ability to drive from the field all competing economic systems.

On the other hand, in the Marxist view, profit is looked upon in this different sort of way:

Over the past 400 years, through its drive to accumulate profits, the capitalist class—by pillage (such as the enclosure movements), murder (wars against and systematic impoverishment of Third World nations), and domination (of workers, consumers, and the political process)—has come to own the resources, factories, and other capital equipment needed to produce goods and services needed by all. Prior to the emergence of capitalism, most people were peasants who owned enough agricultural tools to produce a livelihood. Further, aside from land owned by great landowners like the church and the crown, most land was owned in common. However, gradually peasants were stripped of their tools and their access to land, and in order to live they necessarily became wage-workers for capitalists. At their jobs, workers must produce a value greater than their wage, and this excess is called surplus value. This value, created by labor, is seized by the owner and becomes the owner's profits. Competitive pressures generate the dynamic energy of the system and force capitalists to treat their workers as *things*, commodities to be bought and sold like steel ingots or sheets of plywood. Such pressures also shape many capitalists into predators working against the best interests of the larger society.

It is almost as if two different sets of academics were talking about two different worlds. How can such great divisions of opinion exist between economists when they take a look at something as central to capitalism as the profits that fuel it?

POLITICAL ECONOMY: A GENERAL DESCRIPTION

To describe political economy, in the way that we use the term (and there other schools of thought within the mainstream framework that describe it differently), we will repeat the one we used in the Preface:

Political economy...is more concerned [than mainstream economics] with the relationships of the economic system and its institutions to the rest of

society and social development. It is sensitive to the influence of non-economic factors such as political and social institutions, morality, and ideology in determining economic events. It thus has a *much broader focus* than [mainstream] economics. (Riddell, Shackelford, Stamos, and Schneider, 2009, emphasis added)

Among those who now work in this political economy tradition, as we have described it, there is a variety of differing, often competing, notions about how capitalism works and which way it is heading. Even though there are important distinctions among them, we are able to talk in the same breath about differing schools of thought in political economy because they agree on the following critical points:

1. Although most mainstream economists claim that they are doing “economic science,” their work often fails to explain and predict actual events in the real world—an essential test of any scientific work.
2. A principal reason for this inability to explain real events is the restrictive assumption of “economic man” in mainstream economics, along with a parallel assumption that human beings by nature have unlimited wants for consumer goods.
3. Mainstream models are typically not presented in the historical context that shapes all human events. Furthermore, most mainstream economists have not studied the history of economic ideas, and thus are unaware that the principal assumptions of their analyses have been challenged by political economists for over two centuries.
4. Mainstream economists typically presume a separation between economic activity and political power.
5. Graduate programs in economics are largely confined to mainstream instruction, and a particularly narrow version of that school of thought.

ECONOMICS: THE SCIENCE THAT IS NOT SCIENTIFIC

The debate between the mainstream and political economists about methodology has been going on for a long time. The history of this dispute starts at least as early as the fifteenth and sixteenth century in Europe, when essentially religious explanations of the universe gradually gave way to scientific ones, and with stupendous effects on the world. Columbus’

voyage to the New World, Galileo's telescope, Harvey's findings about blood circulation, and Newton's discovery of certain laws of gravity—along with many similarly astounding discoveries in the seventeenth and eighteenth centuries—made inevitable the declining influence of non-scientific explanations of the world.

The horrific conditions for many workers crowding into European cities since the early eighteenth century led to the development of a new practical science, public health. The public health movement led governments to promote the habits of healthier living and, especially, to construct systems to protect water systems from sewage. This movement was complemented greatly by the discoveries in the nineteenth century of Louis Pasteur and others unveiling the role of invisible bacteria in the spread of disease. Together, public health and biological science led to a dramatic increase in the life span in industrializing nations after the late nineteenth century. The average life expectancy in the United States in 1776 was about 35 years; it was about 50 years in 1900; and by the year 2010, it had reached about 78 years. Research done by the Museum of Natural History shows that, "From 1900 to 1990 we have gained about 25 years of life expectancy; nearly equal to what had been obtained in the preceding 5000 years of human history!"

The success of physical scientists in describing the world and improving the quality and length of life in industrialized countries led others to imitate their work. Economists in particular tried to design regular, law-like models for social phenomena. It is true that in the case of the two most influential economists of the eighteenth and nineteenth centuries, Adam Smith and Karl Marx, the former wrote without mathematics, and Marx confined his quantitative analysis to a few simple algebraic notations. However, by the late nineteenth century most economists had adopted some version of the "scientific method" as their approach and, in doing so, marshaled the economics profession toward mathematics and statistics.

Also during the nineteenth century, economists borrowed the idea of "equilibrium" from physics. In doing so, economists made an extraordinary leap of faith about their ability to study and predict human activity. When social theorists use the idea of equilibrium in model building, they are implying that patterns of human life in a fundamental way are analogous to the equilibrating balance of forces in our solar system that keeps Mars from ramming us head on. That is, this idea presumes that the economy is typically *stable*, and when buffeted by forces of social change, will always return to that stability on its own. A critical implication here is that, if the economy is assumed to be stable and, thus, self-correcting, it is better to allow it to function on its own,

without extensive government interference. Equilibrating systems, whether among the planets or in people's activity, suggested to Adam Smith and to many economists after him, that they were "natural," and this meant they were "God's work." Smith also believed that individuals possessed a natural self-interest that would lead to "the best of all possible worlds," an idea whose modern embodiment we will take up in detail later on.

Alfred Marshall, an influential British economist writing in the late-nineteenth century, was particularly important to the shift from the imprecision of discursive economic language to the precision of quantitative models that incorporated the idea of equilibrium. Though Marshall warned that "economics cannot be compared with the exact physical sciences," he still believed that economics was specially "advantaged" over the other social sciences. He argued:

[A] person's motives . . . can be approximately measured by the sum of money, which he will just give up in order to secure a desired satisfaction; or again by the sum which is just required to induce him to undergo a certain fatigue. (Quoted in Riddell, Shackelford, Stamos, and Schneider 2009, 8)

This means that the prices we pay for products, the amount we invest to try to make profits, and the wage that will induce us to go to work, are all *numbers*, that is, numerical *quantities* that can be manipulated by mathematics and analyzed by economists. Marshall and most of his contemporaries thought that the focus of economists should be the prices that emerge in what he called "the ordinary business of life." This meant, for example, learning how self-interested individuals established prices for products, labor (wages), and money (interest rates) in competitive markets.

Marshall and his contemporaries recognized the aggregate economy as cyclical; however, they also thought it was actually formed by all the individual markets added together, and essentially behaved no differently than would a single one of them. Competitive markets were thought to work with equilibrating precision, and in the hands of Marshall supply and demand, acting as "two blades of the same pair of scissors," were the prime determinants of market price.

Complementing Marshall's system, and developing along with it, was the work of economists who saw markets as driven by "marginal" decisions made by producers, consumers, and workers, that is, decisions about whether to produce an additional unit of production, to purchase an additional item of consumption, or to work an additional unit of labor time. In this

theoretical world, capitalists made decisions by projecting the revenue and cost—thus also the profit—of the next marginal unit to be produced; and consumers made decisions by comparing the marginal satisfaction anticipated from a product to its marginal cost. Some practitioners of this sort of analysis, who were called “marginalists,” even imagined a system of mathematical notations incorporating the marginal decisions of all economic actors into one giant quantitative model.

The marginalists, in focusing their microscope on the margin of economic actions, were especially important in prompting economists to think narrowly, an ironic consequence of their desire to explain everything with a single giant model. Their method implied the fateful idea that the institutional structure of capitalism outside individual markets, such as its system of social classes and the distribution of income and power, was not within the scope of economics. Marginal analysis also implied an extremely limited role for government. If the system was the outcome of a limitless number of individual marginal decisions made in self-regulating markets, then the thick fist of the government could not be expected to solve any economic problem.

In 1879, Marshall published the prototype for the modern economics textbook, which he called *Industry and Trade*. By 1890, he was calling his book *Principles of Economics*, and in this version, the geometric models of supply and demand that all principles students must now learn appeared as footnotes. Though Marshall kept the diagrams in his footnotes, economists who followed with their own principles texts gradually moved the diagrams from the footnotes up to the text where they came to dominate. Thus began the joyful birth, or sad decline, depending on your point of view, of twentieth-century economics.

Further leading to quantification of economics was the theorizing of the British economist John Maynard Keynes. In his revolutionizing book, *The General Theory of Employment, Interest, and Money*, Keynes used geometry, mathematics, and compelling and elegant prose to revolutionize the way that modern economists think about the business cycle. Keynes’ work gradually won over most economists in the capitalist world. He preferred a dense prose to mathematics or geometry as a way to express his economic theories, and he differed crucially from almost all his predecessors by arguing that capitalism was not a self-equilibrating system. Nevertheless, Keynes’ followers constructed diagrams and formulae to carry his theories forward, and these “macroeconomic” models, like the market analysis of Alfred Marshall and the marginalists, successfully lured more and more economists into the encapsulating and often suffocating web of a geometric world.

In 1948, Paul Samuelson of MIT, using his own two-volume mathematical expression of mainstream economics as a model, wrote the first widely used economics textbook. He combined Marshallian analysis, by then called “microeconomics,” and Keynesian macroeconomics and called his book *Economics*. This title was, of course, greatly misleading given all the many kinds of economic analysis, most especially political economy, that he simply ignored. Samuelson, in updating his book over the years, gradually added considerable non-quantitative materials, but the geometric models and other quantitative materials that make up the theoretical core of mainstream economics remained central. Samuelson’s amalgamation of microeconomics and macroeconomics has come to be called “neoclassical” economics, and within the economics profession, this term is the common way to describe mainstream economics.

Is this mainstream amalgamation actually doing *science*? To the critique that they have left too many crucial aspects of social life out of their models, mainstream economists typically respond with something like this: “Our assumptions might be unrealistic, and our models might be narrowly conceived, but they work better to predict economic behavior than the theories of our competitors.” That is, the proof of models is how well they work.

Well, then, how well *do* they work? A good way to answer this key question is to compare the predictions made by economists to those made by *real* scientists. Consider the example of physicists. It is beyond dispute that they know some things, such as the laws of gravity, more or less for sure. Similarly, while medical doctors may differ on particular diagnoses, they know countless things with a high degree of certainty, such as specific physiological dimensions of, and limitations of, the human body. On the basis of highly predictable outcomes, physicists, medical doctors, and other real scientists have enabled human beings to live longer and utterly transform their natural habitat. All these outcomes stem from a scientific method whereby scientists all over the world test hypotheses over and over again until there is wide-spread agreement about this or that aspect of the physical world, or in the case of medical scientists, this or that aspect of the human body.

Yet, and this is the point, there is nothing similar in the annals of economics, and there can never be a set of principles, models, theories, conclusions, or predictions comparable to those in the physical sciences on which economists base their methods of inquiry. We are not questioning whether mainstream economists work diligently and honestly, as real scientists do. Nonetheless, economists don’t know with any degree of certainty what is going to happen in the next instance with respect to much of *anything*. And

that is why they always disagree about virtually *everything*. To make the point, we've constructed below a list of central questions about how the capitalist economy operates. As you study economics, no matter what version of it, you will discover that *there is not now, nor has there ever been*, widespread agreement on the answers to these questions among people calling themselves economists:

- How should we measure the unemployment rate, and what will it be next month?
- Will the economy expand and grow over the next month, or over the next year?
- What will happen to total output if the government increases or reduces personal income taxes?
- How do you measure inflation, and how does it affect different groups of people?
- What has caused capitalism to dominate its rivals? Is it economic freedom? Is it competition? Is it greed? Is it imperialism? Is it brilliant entrepreneurship? Is it the surplus value taken from the hands of workers and used to enrich capitalists and allow them to buy more machines, raw materials, labor-power and political influence?
- Why are people rich or poor in capitalism? Luck? Greed? Connections? Hard work and perseverance? Disadvantages due to race and gender?
- Does free-market capitalism generate the kind of competition that forces firms to operate in society's long-run interest, or do firms, unregulated, run roughshod over workers, small rivals, consumers, and needy politicians, and promote environmental degradation?
- Is economic power distinct from political power; and if they are not distinct, how are they meshed? How do they affect wages, profits, laws regulating the economy, interest rates, prices, exports, and imports?
- Is growth in Gross Domestic Product (GDP) a good thing, or a bad thing?
- Is the Federal Reserve System a "neutral monitor" of monetary policy, or primarily concerned with protecting the interests of wealthy bondholders?
- Is a certain amount of unemployment a good thing for capitalism?
- Does capitalism "provide economic freedom directly [and] also promote political freedom" (Milton Friedman, 1963)? Or is advocating capitalism "like the elephant running through the chicken yard, yelling, 'Everyone for himself!'" (Lester Pearson, past Prime Minister of Canada, 1963)?

If you were to choose at random any professional economist in the world and ask that person any question on the list above, *there is no way to know in advance what his or her answer will be*. If this were true, for example, of the science of physics, who among us would be brave enough to stroll across a bridge or fly in an airplane?

ECONOMIC MAN IN MAINSTREAM THEORIZING

In the view of political economists, the unrealistic treatment of how people behave in capitalist societies is a critical flaw in mainstream economics. The essential assumption of neoclassical economics is that people are self-interested, pleasure-maximizing automatons who respond in predictable ways to all stimuli. This theoretical creature is called “economic man,” or sometimes “rational man,” and this man is not the kind of human being the rest of us would ever know or want to be.

On this point of human behavior and mainstream models, we can usefully turn to John Kenneth Galbraith, one of the most famous modern American political economists, and about whom there is a chapter in this book. Galbraith, a long-time critic of mainstream economics, wrote that the idea of economic man forms part of a rigid system of thought. According to him, this system:

...requires that the ultimately valid propositions of economics be essentially given, like the structure of neutrons, protons, atoms and molecules. Once fully discovered they are known forever. Unchanging also, it is held, is human motivation in a competitive market economy. Such fixed and permanent truths allow economists to view their subject as a science... From this closed intellectual exercise, which is fascinating to its participants, intruders and critics are excluded often by their own choice, as being technically unqualified. And, a more significant matter, so is the reality of economic life, which, alas, is not, in its varied disorder, suitable for mathematical replication. (Galbraith 1987, 284-5)

Along with Galbraith, we do not contest the idea that most human beings will try to serve their own long-term interests as well as they can. It is reasonable to assume that in capitalist societies, most of us will seek rewards from the marketplace, whatever our role in it. Yet this readily-observable fact cannot help us to know, simply by looking at another human being, what he or she will do in the market *at the next moment*. It is the central practice of real scientists to experiment with the objects of their study until,

in their labs, they come to know with some confidence what consistently will happen to Y if they change X. This is not what mainstream economists do because their subject is human behavior, something we have never been able to predict with the kind of confidence that makes real science possible. Therefore, while the scientists are doing science, economists are, as John Maynard Keynes argued, engaging in an exercise in logic based on assumptions that are adopted because they can be quantified, not because they are true or even sensible.

We want to make our point carefully here, so repetition is in order. We recognize that there are broad patterns of behavior in capitalist markets that are predictable. In fact, almost all of us order our individual worlds in terms of these patterns of behavior. However, to go from *broadly predictable* patterns of behavior to the assumption that all of us, all the time, have the knowledge, time, and inclination to maximize economic gains, carries us from reasonable observation to basing economic models on a badly distorted mirror of real human activity. For example, in order to predict consumer behavior, neoclassical models usually assume that all people have perfect information about all of the goods that they might want to buy, they know all of the prices and qualities involved, they know how much satisfaction they will receive from each product if they buy it, and they are completely rational and self-centered. These assumptions imply that when we shop we are not influenced by store displays or impulses that might interfere with the rational calculation of which good will bring the greatest satisfaction to us per dollar we spend. The assumptions also deny that some of us might actually buy more expensive or slightly lower-quality goods because they are produced under better environmental and labor conditions; that is, they ignore the idea that people might value justice, and not just pleasure. The mainstream view of how human beings shop in modern capitalist cultures is, to put the best light on it, quixotic.

There is a further problem here. In mainstream economics, economic man has also long been the idea of “man with unlimited wants.” William Rohlfs reveals this central assumption in his mainstream introductory text. As he argues:

The fundamental problem facing individuals and societies alike is the fact that our wants exceed our capacity for satisfying those wants. (Rohlfs 1998, 4.)

What is wrong with this statement? Notably, it is outside history: it is constructed for the sake of analysis rather than inferred from what human beings

have actually done. As such, Rohlfs bases the economic analysis that follows in his book on a “made-up” human being. Thorstein Veblen, whose ideas we will take up in a later chapter, recognized the failure of this model to explain the complicated ways in which people’s desires are actually shaped. Veblen saw economic man as central to what he called “the hedonistic approach” to economics, his description of the central economics tradition in his own day. By using the term “hedonistic,” Veblen meant that humans are looked upon as simple “pleasure machines,” looking only to maximize their own happiness. In 1919, Veblen wrote that he saw actual human beings instead as “products of...hereditary traits and past experience cumulatively wrought out under a given body of traditions, eventualities, and material circumstances.” (Veblen 1919)

What, then, do we think human beings actually are, for the purposes of studying their economic behavior? For an answer from political economy, we extend these comments from Veblen with some evidence from history.

ECONOMIC MAN AND HUMAN HISTORY

One of the most renowned economists of the twentieth century, Joseph Schumpeter, proclaimed that:

What distinguishes the “scientific” economist from all other people who think, talk, and write about economic topics is a command of techniques that we class under three heads: history, statistics, and theory...Of these fundamental fields, economic history—which issues into and includes present-day facts—is by far the most important...If starting my work in economics afresh, I were told that I could study only one of these three but could have my choice, it would be economic history that I should choose. (Schumpeter 1954, 12)

History was an essential part of economic analysis, according to Schumpeter, for three reasons. First, a grounding in economic history allows the analyst to understand present economic activity as a key element in the evolutionary changes inherent to social life, and that today is but a single point in the life process; and all that makes up society will be different tomorrow. Second, historical analysis incorporates important institutional “data” that are often excluded from mainstream economic analysis. Finally, Schumpeter argued that those who fail to examine the historical record are likely to commit “fundamental errors” of analysis.

One of the more fundamental errors of mainstream economics has been to insist that the “hedonistic” tendencies of human beings were present from the dawn of time. In fact, the dominant role of these habits has

developed in the relatively short era of world history since the rise of capitalism, mostly by those living after 1500 A.D. in Western Europe and North America. Adam Smith, by observing people in his own time, concluded that human beings “naturally” (which, to him, meant innately and God-given) made exchanges based on self-interested behavior. He subsequently decided that the “propensity to truck, barter and exchange”—to offer a good or service to someone else only in exchange for an equally valued good, service, or the equivalent in money—must also be a natural instinct. Moreover, Smith argued that the self-interested trader would only trade to become better off, due to the profit motive. Hence, transactions between humans in the capitalist age came to be seen as exchanges between two flinty-eyed, rationally-calculating, self-interested beings who were always looking to profit on any deal. Though Smith, in other writing, had argued that people were often motivated by other kinds of sentiment, his followers developed the model of human behavior that we have now, one that leaves little room for other human inclinations such as altruism, sentimentality, or a concern for justice.

Was self-interested exchange a “natural” tendency of humans? When Smith wrote in 1776, he was ignorant of, or ignored, the writings of those historians of the ancient world who had described a very different system of exchange in the economies of Greece and Rome. In these civilizations, exchange most often took the form of elaborate systems of reciprocity or redistribution. Ancient Babylon and Egypt both operated systems of redistribution whereby most of the produce of the nation was collected, recorded, and then placed in centralized storehouses. In lean times (to which these primarily agricultural civilizations were especially susceptible), the stored produce was not sold to the highest bidder, but redistributed to all of the citizens, be they peasant, weaver, or potter, according to their needs. These economies were organized along the lines of gigantic households, in which all members of the society were expected to make their contribution to the household and in turn to share in the nation’s produce. The Biblical story of Joseph describes just such a redistributive system as well as the rationale for the redistribution based on collective capacities and collective needs, rather than individualistic exchange. Recall that the brothers of Joseph, after selling him into slavery years before, came to Egypt in hopes of asking for some of the stored grains so that they could survive the famine in their native land of Canaan. Joseph, in his capacity as manager of the Pharaoh’s stores of grains, gave generously to his brothers, despite their mistreatment of him so many years earlier.

Other exchanges often took place for honorific or social purposes, rather than for economic gain. Another Biblical example describes the honorific exchange between King Solomon of Israel and King Hiram of Tyre. Hiram offered Solomon all the cedar and fir trees that he needed for the temple he planned to build, and in exchange Solomon offered him wheat and oil. This was not economic exchange but an exchange of tributes. (1 Kings, 5) Economic historian Karl Polanyi described many such systems of reciprocity—for example, giving gifts of fruit to kin and receiving in return gifts of fish—which existed in pre-capitalist societies. Polanyi argued that this was not barter and trade, but rather a socially organized system of reciprocity, based on sharing with the rest of the community. To sum up, in *The Great Transformation*, Polanyi argued:

[A]ll economic systems known to us up to the end of feudalism in Western Europe were organized either on the principles of reciprocity or redistribution, or householding, or some combination of the three....In this framework, the orderly production and distribution of goods was secured through a great variety of individual motives...Among these motives gain was not prominent. (Polanyi 1944, 55)

The obvious implication of Polanyi's point is that the mainstream argument—that self-interest and the instinct to barter and trade is a *natural* trait of human beings—is at odds with historical evidence. The most we can say is that self-interested behavior came to be rewarded in pecuniary terms during the short span of human history that has elapsed since the rise of capitalism, and that five hundred years of capitalism have probably reinforced self-interested behavior in ways that make it difficult to suppress. But the latter is a very different proposition than to argue that self-interest is inherent in human behavior. And, in some societies even though most economic activity is carried out by private firms—such as in Sweden—public policy is nevertheless based upon such human motivation as generosity and reciprocity, rather than on the assumption that all people are greedy in all their transactions. Furthermore, as Adam Smith and others have argued, even those individuals who normally engaged in self-interested behavior often act selflessly on behalf of friends, family and the community.

Space does not allow us to tell the stories of how the first markets emerged and then became the ubiquitous markets of economic theory, or how the human yearning to be productive and creative came to be twisted into a labor-leisure tradeoff in modern economics. Suffice it to say that a careful study of

history is an essential part of economic analysis and, to borrow an idea from philosopher George Santayana, we might say that economists who ignore history are doomed grievously to misinterpret it. Whether using the lessons of history in formulating present-day policies to make a better future, or testing the theories of modern economics against all of the learning of historians, history is indeed an essential part of the study of economics.

THE MYTHICAL SEPARATION IN THE MAINSTREAM BETWEEN ECONOMICS AND POLITICAL POWER

In addition to concluding that mainstream economics has peopled its models with creatures existing in a historical, psychological, and cultural vacuum, political economists are also highly critical of the mainstream presumption that economics is distinct from politics or power. As a typical example from one economic principles text (an example picked at random from a shelf of them), consider the following statement:

How did the very wealthy get that way? Of the 400 people on the *Forbes* magazine list of the richest people in America (with an average wealth of about \$500 million each), about one-fourth got rich through inheritance. The other three-fourths, such as Bill Gates of Microsoft, got rich through working, starting their own businesses, inventing new products, and so on. (Stockman 1999, 425)

In this excerpt and throughout his book, Stockman avoids mention of government, the legal system, or any other institutions related to political power that might have played a role in helping the Fortune 400 amass their wealth. In fact, wealth accumulates in any society, either from inheritance or some other way, *because the laws allow it to happen*. For instance, as recently as 1959 the highest federal marginal tax rate was 91% for all personal income over \$200,000! Since then, the laws have been changed, and in 2015 the highest marginal rate—for a couple's income over \$466,951—was 39.6%. In other words, in 2015 the Fortune 400 accumulated their wealth faster than in 1959 partly because lawmakers changed the laws on their behalf. By comparison, Sweden's welfare state provides all citizens, among other benefits, health care and schooling, and to pay for these benefits Swedes pay over *half* their income in the form of taxes. In the United States, the average tax rate is about 21%, meaning that we have a very different set of rules regarding how much wealth and income individuals keep for themselves and how much will be used for broader, social purposes.

Journalists Donald Bartlett and James Steele (in *America: Who Really Pays the Taxes?*, 1994) demonstrated the extent to which U.S. corporations are subsidized by governments through low or even nonexistent taxes, and by direct subsidy payments. They discovered innumerable examples of this practice, such as government subsidies totaling over \$100 million a year to McDonald's, M&M/Mars, and other companies marketing their goods abroad. In 1999, *Time* magazine updated this research and concluded that in 1997 corporations received almost \$200 billion in subsidies from state, local, and federal agencies. This huge flow of government payments exemplifies the power of corporations to shape political decisions in their favor, a power that is denied to virtually all citizens except the very wealthy. When did *you* last impose your economic interests on a U.S. senator or the president, as the owners of large corporations do on a regular basis?

Corporations are able to impose their agendas in this way partly because through their lobbyists they channel enormous sums of money to politicians. One effect of these payments in the past several decades has been lax enforcement of anti-monopoly laws by the anti-trust division of the U.S. Justice Department. Presidents Ronald Reagan, George Bush, Bill Clinton, George W. Bush, and Barack Obama, who in succession directed anti-trust policy, encouraged the marriage of mammoth corporations, such as the \$170 billion merger between Exxon and one of its major rivals, Mobil Oil, and the one between Time/Warner and America Online, which created a \$350 billion behemoth (and subsequently failed). Mergers of this order are sold to the public on the grounds that only giant conglomerates can provide the high-quality, low-priced goods for which we are supposed to clamor. Yet, mergers can as often as not mean less competition, higher prices, and a growing challenge to democratic rights in areas where they operate. The social consequences of allowing mergers and other forms of deregulation were exemplified most dramatically by the financial crisis of 2007-2010 where a long, successful lobbying effort led to the deregulation of certain activities of financial firms, and in turn led to the financial crisis and Great Recession.

Our point here is important if we are to distinguish adequately between mainstream economics and political economy. To the former, political power is most often considered part of the background institutional structure which is, as they put it, "taken as a given" and thus is left to political "scientists" or others to worry about. It is this determination to ignore the political consequences of concentrated economic power in capitalism that allows conservative mainstream economists such as Milton Friedman to argue that capitalism always

“promotes political freedom.” For their part, political economists see capitalism as *intrinsically political*: the capitalist workplace often is a rigid hierarchy of control, and the allegedly “neutral” government acts disproportionately—as even reasonably alert children now know—in the service of the rich and powerful.

Karl Marx suggested that the government in modern capitalist countries is “the executive committee of the capitalist class,” that is, of the rich and the powerful. As you will likely discover in an economics principles course, income inequality is now greater in the United States than in any other advanced capitalist society, and it has consistently been among the most unequal for over two centuries. This is the case because our laws allow it. The political economist might explain why Bill Gates is worth over \$80 *billion*, while in 2015 over *twenty-eight million* people in the United States did not have health insurance: powerful people and corporations have consistently led efforts in the United States to fight the Affordable Care Act, while they have spent lavishly to ensure that lawmakers make rules of the capitalist game that allow individuals to accumulate vast fortunes. This political economy view is quite a different explanation from the theory of income distribution that Stockman suggests—the idea that most people get what they earn primarily through hard work and creativity.

THE SPREAD OF MAINSTREAM ECONOMICS AND ITS PROBLEMS WITH REALITY

Despite the many serious limitations of mainstream economics, it has maintained its dominance over economic thinking in the U.S., both off and on the campus. It’s a cat with considerably more than nine lives, but the “Great Recession” of 2007-2010 proved once again that this body of quasi-scientific ideology cannot adequately explain the real world.

As we noted earlier, MIT economist Paul Samuelson fused Marshallian microeconomics with a mathematized version of the macroeconomics of John Maynard Keynes to construct what he and others called the “neoclassical synthesis.” He used this foundation to publish the first edition of a textbook called, simply, *Economics*, one that set the stage for the eventual dominance of mainstream economics over all its heterodox competitors. Its basic template also became the one used for almost all economic principles texts thereafter. The mind-numbing narrowness of this synthesis was surpassed only by the arrogance of its title, *Economics*, implying that everything that might legitimately be said about the subject was *inside the book*. In the first and later editions of the text Samuelson mentioned heterodox ideas rarely, and when he did it was usually in order to demean them (as we shall see).

Other influential textbook writers adopted a similar approach, ignoring or caricaturing heterodox ideas. For example, among the most popular principles texts through the 1960-1980 period was *Economics: Principles, Problems, Decisions*, by Edwin Mansfield, an expert on efficiency who consulted for such firms as Exxon and Mobil. As an example of Mansfield's dismissal of the relevance of heterodox economics, his 1974 version had 717 pages, and only four of them were dedicated to alternative ideas, with most of the language used as an opportunity to dismiss Marx. Mansfield later expanded to intermediate economics textbooks, and altogether he sold "several million copies [that were] adopted at over 1,000 U.S. colleges and universities, and were translated and widely used abroad." (University of Pennsylvania, *Almanac*, November 25, 1997) This flight from alternative economic ideas in textbooks imposed on students, and especially the flight from the ideas of Marx, occurred during the Cold War starting in the late 1940s and continuing until the late 1980s. It was likely safer to dismiss his ideas as those of the evil parent of communism than to see him, like much of the rest of the world does, as a powerful social theorist and historian.

By 1980, Samuelson, responding to the kind of radical political economy that had begun to emerge in then turbulent 1960s, sank to banal sarcasm in his treatment of ideas outside his neoclassical synthesis. Of the 829 pages of that year's edition, sixteen were allocated to the "evolution of economic doctrines." He had this to say about the ideas of John Kenneth Galbraith, one of the most important heterodox economists of the 20th century:

Galbraith's "criticism" cannot itself kill. But, it acts like a virus, softening the way for more deadly critiques by the New Left and its professional radical economists.

This comment was made two decades after Galbraith had written *The Affluent Society* (1958), where he argued prophetically that by championing "free" markets and limited government, mainstream economists were an important cause of the "social imbalance," by which we overwhelm our society with too many consumer goods and too few public ones. Samuelson also added a twelve-page appendix summarizing his view of the principal ideas in the thousands of pages of Marx's books, pamphlets, letters, and speeches. In the conclusion, he wrote that, "The use of Marxian categories did all too often addle the wits of those hoping to understand the realistic laws of motion of Western Economic Systems." Without question, these are the words of someone who, for all his clever-

ness, was badly misled by the idea that he was doing science, where economic laws are the equivalent of those in physics.

The flood of neoclassical texts that followed Samuelson's 1948 book cemented the overwhelming dominance of the mainstream version of economics in U.S. higher education. There were alternatives that came along, and there were many more textbooks in the specialized fields that included, or were based on, heterodox ideas. But the mainstream won the textbook war due to its control of graduate programs and economics departments, rather than the usefulness of its ideas. In the early 2000s the most popular mainstream principles textbook was *Principles of Economics* by N. Gregory Mankiw. Its 2015 edition has 800 pages, but does not mention Marx and completely ignores virtually every other heterodox luminary in the history of Western economic thought. Exemplifying the underlying market-worship in Mankiw's book, an all-pervasive prejudice that he clearly does not recognize, he writes that, "Although some of the arguments [for foreign trade restrictions] have some merit in some cases, *economists* believe that free trade is usually the better policy" (emphasis supplied). Similarly, he states, "*Economists* view the United States as an ongoing experiment that confirms the benefits of free trade" (Mankiw, *Principles of Economics*, Cengage, 2015, p. 188, emphasis supplied). Heterodox economists have long documented the many negative effects of free trade, including the practice of international firms to seek out the cheapest possible wages no matter the effect on domestic and foreign labor markets, to ignore environmental regulations in countries that can't control them, and often to add dramatically to income inequality. Mankiw's combination of arrogance and ignorance is clear in his claim that to be an "economist" one must believe in free trade, an idea we explore in the box on the theory of comparative advantage on p. 20.

It is impossible to know for sure, but a reasonable guess is that well over 90% of all economics students in the United States are currently grilled in the mainstream of economics, and alternative views, at best, are tacked on along the way. The fact that the overwhelming majority of economics students in the United States will have learned about demand elasticity but not about Marx, Veblen, Galbraith, or the sharp criticism of quantitative economics made by Keynes, is brainwashing, no matter how you look at it.

FREE-MARKET IDEOLOGY AND THE REAL WORLD

Because so much of mainstream economics is dream work, rather than plausible arguments based on what people actually do, its theories and models are bound at times to fail quite miserably. One of the most dramatic examples was the failure of mainstream economists to foresee the financial melt-

down that began in 2005 and led to the deep recession beginning in 2007. Though there were many causes for this crisis, it began with the collapse of the U.S. financial markets, and that occurred in large part because of lack of adequate regulation of the financial industry.

As early as 1994, members of Congress and later some federal regulators called for stricter rules to deal with the huge growth in very complex financial instruments, especially those known as derivatives. In 1998, one such

THE THEORY OF COMPARATIVE ADVANTAGE
Or, A Simpleton's Guide to International Trade

Mainstream economists' support for unregulated ("free") trade can be traced back to the Theory of Comparative Advantage, developed by David Ricardo in 1817. According to this theory, a country should specialize in producing those goods that it can produce for the lowest opportunity cost. In essence, each country should specialize in and export what it can produce for the least cost, and import goods that other countries are better at producing. That way, unregulated trade will result in maximum global productivity and increased standards of living. If that story seems too simplistic to you, then you are on your way to becoming a political economist.

What's wrong with this story? Political economists have written many thousands of pages on that topic. But let's briefly go through a few key problems.

First, the idea that free trade is a positive economic development policy for countries to follow is ahistorical and inaccurate. Ricardo and others living in England in the 1800s promoted unregulated trade at a time when such policies were clearly advantageous to England! As the world's first country to industrialize, England had an advantage over other countries and unregulated trade would allow British industries to dominate manufacturing industries in other countries. As Ha-Joon Chang, a political economist at the University of Cambridge, has pointed out in numerous books and articles, today's wealthiest countries successfully developed not via unregulated trade but by protecting and promoting key industries. No country has successfully developed its economy via unregulated trade.

Second, the theory of comparative advantage is mostly wrong when it comes to explaining global trade patterns. For example, it is true that African countries tend to specialize in producing raw materials and that European countries tend to specialize in manufactured goods. But it is impossible to discount the role of colonialism in destroying manufacturing in Africa and supporting manufacturing in Europe as an essential reason for this outcome, not the "efficiency" of the market system and free trade. Also, countries like the United States both import and export manufactured goods—we simultaneously have comparative advantages and disadvantages in the same products! Thus, the theory of comparative advantage offers little that is useful in understanding international trade. And yet, it remains a cornerstone of the ideological artifice of mainstream economics and leads to such comments as the one by Gregory Mankiw with which we prefaced this analysis of such trade.

regulator, Brooksley Born, vigorously pressed for rules to regulate the derivatives market, but she met with stiff resistance from Robert Rubin, the Treasury Secretary, and Alan Greenspan, head of the Federal Reserve System (known as “the Fed”). Both of Born’s critics were adamant that a federally regulated financial system could not possibly compete with the wonderful outcomes that they were certain would come from free markets. In holding this view, they were, of course, marching arm-in-arm with the majority of mainstream economists for whom deregulation is a crucial element in the path to free market utopia. In fact, two such economists, Myron Scholes and Robert Merton, won the 1997 Nobel Prize for Economic Science for creating a mathematical model for evaluating derivatives. Ironically, a principal reason given for awarding Scholes and Merton the prize was that their model had, “generated new types of financial instruments and facilitated more efficient risk management in society.”

We will focus on the major player in this battle over regulation, Alan Greenspan, because he was an economist with mainstream, pro-market biases, and his role in this crisis was pivotal. His actions also provide cautionary evidence of what can happen when people with these ideas in their heads get real political power. As background experience to become head of the Fed, and thus the presumed neutral arbitrator of U.S. economic policy, Greenspan had been a financial consultant for thirty years before he joined the Fed. He was also a long-time fan of Ayn Rand, a defender of individualism and free market capitalism, and he has described himself as a “libertarian Republican.” Along his libertarian way, he was an advisor to Richard Nixon, and was a corporate director for such giants as Aluminum Company of America (Alcoa); Automatic Data Processing, Inc.; Capital Cities/ABC, Inc.; J.P. Morgan & Co., Inc.; Mobil Corporation; and The Pittston Company.

This bundle of experiences apparently strengthened Greenspan’s view that government regulation was to be resisted at all costs, and there is ample evidence that he was among the most important foes, if not *the most* important foe, of regulation of the financial markets during his time at the Fed. Key details of his role in the matter are supplied in an article entitled, “What Went Wrong,” written by Anthony Faiola, Ellen Nakashima and Jill Drew (*Washington Post*, Oct. 15, 2008). They argue that while derivatives did not trigger the collapse, their “proliferation, and uncertainty about their real values, accelerated the collapse of the [huge investment firms] and magnified the panic that has since crippled the global financial system.” These writers suggest strongly that no one worked harder than Greenspan to keep derivatives from being regulated. In one 1998 meeting with Brooksley Born, when

she said her agency was under attack for pushing for regulations of derivatives, Greenspan responded to her sharply and said, "Regulation of derivatives transactions that are privately negotiated by professionals is unnecessary. Regulation that serves no useful purpose hinders the efficiency of markets to enlarge standards of living." Arthur Levitt, who was head of the Securities and Exchange Commission and frequently met with Greenspan to discuss regulating derivatives said that, "The Fed was really adamantly opposed to any form of regulation whatsoever."

Ten years after dressing down Born, after the financial crisis had begun, Greenspan appeared in congressional hearings led by Henry Waxman, a Democrat from California. Here is how that exchange is reported by David Leonhardt in the *New York Times*, Oct. 23, 2008:

Greenspan admitted fault in opposing regulation of derivatives and acknowledged that financial institutions didn't protect shareholders and investments as well as he expected. [Waxman asked him] "In other words, you found that your view of the world, your ideology, was not right, it was not working." "Absolutely, precisely," Greenspan replied. "You know, that's precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well."

Things had, indeed, been going well for Alan Greenspan from 1968 to 1987 while he was consulting for investment firms and helping to direct huge capitalist firms. The good times continued for him during his years running the Fed, from 1987 to 2006. During that period, the economy mostly expanded, and though the truth of the matter is not known or knowable, Greenspan was given a good deal of the credit for that expansion. Corporations enjoyed growing profits and shared Greenspan's affection for deregulation; politicians found it easier to be elected with a growing economy; and the media had already started mixing up celebrity gossip with other news, and they became central to making Greenspan an economic hero. None of this cheering crowd, however, took a look at other things that were happening. And none of this crowd heeded the warnings of Marx, Veblen, Keynes, and Galbraith that market speculation regularly results in economic crises.

In fact, during Greenspan's tenure at the Fed real wages for workers remained virtually the same while the income of the corporate elite and other rich people skyrocketed. In those two decades, one of the two greatest *upward* redistributions of income occurred; as one consequence, the ratio of CEO sal-

aries to the average wage of their workers went from about 40:1 to about 500:1. The stagnation of wages at the bottom which prompted greater and greater consumer indebtedness, and the increasingly rampant speculation at the top during the era of deregulation, created the environment for a financial crisis that many heterodox economists (and almost no mainstream economists) saw coming. The great “Maestro,” as Bob Woodward called Greenspan in his adoring book of that title, was a key player in establishing the inequality and unregulated environment that brought us all down into a recession that badly threatened the welfare of much of the population of the world.

All this raises an interesting question: has any of this real-world experience, that seems to make a mockery of much of mainstream economics, with its rational actors, equilibrating markets, and championing of the unregulated free market, diminished its parishioners’ faith in their way of doing things? Probably not.

Patricia Cohen, who took a look at the matter, summarizes her conclusion with the title of an article, “Ivory Tower Unswayed by Crashing Economy?” in the *New York Times*, March 5, 2009. She writes this essential summary of her argument:

[In the wake of the financial collapse] prominent economics professors say their academic discipline isn’t shifting nearly as much as some people might think. Free market theory, mathematical models and hostility to government regulation still reign in most economics departments at colleges and universities around the country. True, some new approaches have been explored in recent years, particularly by behavioral economists who argue that human psychology is a crucial element in economic decision making. But the belief that people make rational economic decisions and the market automatically adjusts to respond to them still prevails.

She quotes James K. Galbraith, a leading heterodox economist, as saying, “I don’t detect any change at all.” He described the profession as “like an ostrich with its head in the sand.... It’s business as usual. ... I’m not conscious that there is a fundamental re-examination going on in journals.”

These ostriches, to use James Galbraith’s metaphor, are not likely to be pushed aside by graduate students with different ideas, at least not for a long while. Robert Shiller, a Yale economist, told Cohen that graduate students who stray too far from the dominant theory and methods seriously reduce their chances of getting an academic job. He concludes: “I fear that there will not be much change in basic paradigms... The basic curriculum will not change.”

Cohen also reports, “In addition to Berkeley and the University of Texas, professors at a number of departments including those at the University of Chicago, Harvard, Yale and Stanford, say they are unaware of any plans to reassess their curriculums and reading lists, or to rethink the way introductory courses are organized.” Dani Rodrick, a Harvard economist, told her, “The problem wasn’t with the economics but with the economists... We have fixated on one of the possible hundreds of models and elevated that above the others.”

Fixated, indeed, is the right word, and the word becomes “catastrophic” when an economist like Alan Greenspan, fixated on those ideas, maneuvers his way into a position of great power.

WHAT SHOULD ECONOMISTS ACTUALLY DO?

As heterodox economists, we suggest a way of doing economics—a basic methodology—that recognizes the political economy approach from the mainstream one in the following four different ways:

1. We believe that human nature is pliable and conditional, rather than fixed.
2. We make explicit value judgments about the way we think the world ought to be and do not pretend to be purely objective scientists.
3. A central basis of our analysis is empirical and historical (and thus inconclusive), rather than theoretical models typically aimed at being conclusive.
4. We use data and economic models when appropriate, but we pay close attention to the assumptions involved and the limitations of such data and models.
5. The questions we ask, our method of answering them, and all the other aspects of our investigations, are couched in a language designed for all people who want to build a more reasonable world, rather than symbolic jargon accessible only to the few.

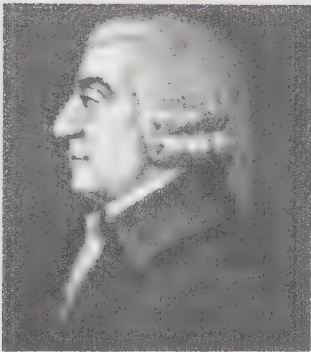
The best way we can demonstrate these basic principles is to turn to the work of those political economists whom we consider among the greatest such practitioners, Adam Smith, Karl Marx, Thorstein Veblen, John Maynard Keynes, John Kenneth Galbraith, and the other voices we draw upon in our survey. They will show us how it’s done.

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2

Adam Smith and the Philosophy of Limited *Laissez-Faire**



I. INTRODUCTION

Adam Smith, one of history's most influential economists and philosophers, lived in Great Britain from 1723 to 1790. His writings on morals and economics have excited controversy ever since he published his two important books, *The Theory of Moral Sentiments* (1759) and *An Inquiry Into the Nature and Causes of the Wealth of Nations* (1776). Economists, in particular, have engaged in heated debates about what Smith "really

meant." The late George J. Stigler, a Nobel Prize-winning conservative economist, offered one particular interpretation of Smith's work. At the *Wealth of Nations* Bicentennial Conference at the University of Glasgow in 1976, Stigler began his talk by saying: "I bring you greetings from Adam Smith, who is alive and well and living in Chicago."¹ He was alluding to the extreme "free market" school of economics at the University of Chicago. The picture that Stigler painted of Smith was that of an advocate of competitive capitalism, free trade, and an efficiently working price mechanism—the same ideas promoted by Chicago economists like Milton Friedman and Arnold Harberger. By focusing his attention narrowly on Book I of the *Wealth of Nations*, especially

* This chapter is a revised and edited version of an essay written by the late Hans E. Jensen, who was a professor of economics at the University of Tennessee, Knoxville. Professor Jensen was a renowned historian of economic thought, who published articles on the works of Clarence Ayres, Thorstein Veblen, John Maynard Keynes, Alfred Marshall, Karl Marx, John Stuart Mill, Joseph A. Schumpeter, and Adam Smith.

Chapter VII,² Stigler argued that Smith's *magnum opus* was an incontrovertible argument for the efficiency of unregulated markets. That some free enterprisers view it as such a sacred document is indicated by the fact that the Association of Private Enterprise Education annually bestows its Adam Smith Award on worthy workers in the vineyard of free-enterprise economics.

However, others challenge this interpretation of Smith as a radical proponent of unregulated markets. For example, Karl Marx considered Smith one of "the best representatives" of "classical political economy," which Marx understood as "that economy which ... has investigated the real relations of production in bourgeois society, in contradistinction to vulgar economy, which deals with appearances only ... and ... seeks plausible explanations of the most obtrusive phenomena."³ Thus Marx implied that Smith had written the *Wealth of Nations* from a *holistic* point of view,⁴ intimating that Smith dealt with the whole economic system and with the interrelations of its constituent parts. Similarly, Horst C. Recktenwald argues that the *Wealth of Nations* must be viewed "comprehensively as an integrated *whole*" focusing on the entire, dynamic macroeconomy.⁵ Thus, rather than narrowly focusing on markets and prices, as many mainstream economists do, Smith was indeed a true political economist interested in constructing a comprehensive picture of the economy within society. The inaccurate picture of Smith results from the fact that mainstream economists usually select a narrow cross section of Smith's writings as the key part of his contribution to economics—generally the passages that focus on the efficiency of markets. This obscures the breadth of Smith's ideas as well as his skepticism about the motives and behaviors of business owners. Smith's ideas have also been distorted when it comes to his attitudes on recessions and austerity, a topic we explore in the box on p. 29.

Smith's purpose in engaging in this holistic analysis was to show how public happiness could be enhanced. He considered this to be an extremely important, and necessary, task because his contemporary society was not "happy" in as much as the "far greater part of ... [its] members ... [were] poor and miserable."⁶ Smith was clearly very much concerned with the welfare of all citizens.

As we will see below, Smith crafted a powerful argument in favor of limited *laissez-faire* in the context of a critique of the mercantilist economic policies that dominated his era, the late eighteenth century in Britain. Whether these ideas apply to the contemporary world will be left to the reader to judge. Furthermore, it will become clear that Smith had deep reservations about the behavior of the wealthy elites of his day, who often seemed to

AUSTERITY IN A RECESSION
A Bad, Non-Smithian Idea Attributed to Smith

As another example of how Smith's ideas have been appropriated and distorted by conservative economists, a simple phrase of Smith's became a hallmark of anti-Keynesian and pro-austerity approaches to government policy. James M. Buchanan and Richard E. Wagner put it thusly in "Democracy in Deficit: The Political Legacy of Lord Keynes":

In the year (1776) of the American Declaration of Independence, Adam Smith observed that "What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom." Until the advent of the "Keynesian revolution" in the middle years of this century, the fiscal conduct of the American Republic was informed by this Smithian principle of fiscal responsibility: Government should not spend without imposing taxes; and government should not place future generations in bondage by deficit financing of public outlays designed to provide temporary and short-lived benefits.

Conservative economists and politicians attacked the notion that governments should run deficits to stabilize economies in crisis, and justified their stance by referring back to Adam Smith. Instead of deficit spending, they promoted austerity in recessions: governments should slash spending to get budget deficits under control. Once they had done so, these economists argued, confidence would return to markets and the recession would end. Austerity would solve the crisis.

First, we might point out that the quotation Buchanan and Wagner use from Smith was, in fact, an argument for free trade, not for austerity in a recession. The full quote from Adam Smith is, "What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage." One wonders at the intellectual gymnastics that Buchanan and Wagner engaged in to spin a quotation from Smith about the benefits of trade into an argument for austerity.

Second, and more importantly, austerity has never worked to correct a recession, as Mark Blyth documented in his book, *Austerity: The History of a Dangerous Idea*. Countries in Europe that responded with austerity to the financial crisis that started in 2007, and to the resulting Great Recession, experienced declines in economic growth and increasing deficits. Austerity in a fragile economy invariably eliminates jobs and erodes consumer and investor confidence once spending cuts are undertaken, as happened in the Great Depression and as has occurred in every other major economic crisis where austerity was attempted. Austerity pushes the economy deeper into recession, causing additional declines in jobs and tax revenues as economic activity contracts further, forcing the government to engage in new bouts of austerity (if they stick with that approach). It is a recipe for disaster, as we have known since John Maynard Keynes addressed this issue during the Great Depression, and as we will study in Chapter 5 below.

profit at the expense of the public thanks to political connections and rigged markets. It will again be left to the reader to determine how Smith would feel about the concentration of economic and political power today. In addition, to emphasize how misleading the “Chicago view” of Smith’s work is, this chapter will demonstrate that Smith considered the alleviation of poverty to be the central priority of an economic system, and he supported public measures such as building infrastructure and providing education that would improve the functioning of the market system. These ideas suggest that Smith was a far more subtle and complex thinker than he is often made out to be, and that he was very much a political economist (as we defined it in the previous chapter) with a broad understanding of the institutional foundations of a market economy.

To substantiate these claims, the chapter will endeavor to indicate what Smith really *said* in his works, rather than what we or others claim he really meant. Inasmuch as he is not around to tell us what he meant, one can do no better than ascertain what Smith said—in the hope that his writings might reflect what he meant. As Samuel Hollander observed, textual interpretation is no easy matter.⁷ For this reason, we try to avoid assertions about what Smith said, using direct quotations as far as practicable. We begin our inquiry by reporting on what Smith said about his concerns and objectives as a practitioner of political economics.

II. SMITH’S OBJECTIVES

Smith said that he wrote the *Wealth of Nations* in order to explain how rampant poverty among the “labouring poor” could be eliminated from this “great body of the people.” He observed that poverty has to be measured by the rate of “mortality . . . among the children of the common people.” He noted that “half of mankind die before 5 years of age. But this is the case only with the meaner and poorer sort, whose children are neglected and exposed to many hardships from the inclemencies of the weather and other dangers.”⁹ Smith’s “sympathies went,” therefore, “wholly to the [poverty-stricken] labourer” and his family.¹⁰ As his first biographer put it, the *Wealth of Nations* served Smith as an outlet for his “ruling passion, of contributing to the happiness and the improvement of society” through the elimination of working-class poverty.¹¹ Hence he declared it to be his objective to identify those processes that must be encouraged in order to bring forth a “well-governed society, [in which] . . . universal opulence extends itself to the lowest ranks of the people.”¹² In this state of affairs, so “great a quantity of every thing is produced that there is enough both to gratify the slothful and oppressive profu-

sion of the great, and at the same time abundantly to supply the wants of the artisan, [the labourer], and the peasant.”¹³ In this latter quotation, we can see Smith’s antagonism towards the rich and powerful of his era, as well as his emphasis on raising the standard of living of the working class.

As we shall see, Adam Smith attempts to identify the economic institutions and policies that would best enable his society, eighteenth-century England, to achieve economic growth and alleviate poverty. He argued that economic growth came from greater productivity and innovation, but that only in the right context, with the right incentives and the correct economic policies, would innovation turn into economic growth.

III. SMITH ON GROWTH AND DEVELOPMENT

How did Smith envision that increased wealth of the entire nation would come about? There is only one way: The annual “produce” of the nation must come to bear “a greater ... proportion to the number of those who are to consume it.”¹⁴ In other words, economic growth must occur. And the incomes generated by growth must be distributed in such a way that the conditions of the poor improve, even while the “slothful and oppressive” elites maintain their lifestyles. Smith’s focus on economic development through growth led him to investigate those forces that contribute to or hinder growth. This he saw as the essence of economics. Hence he defined “Political Oeconomy” as the study of “the nature and causes of the wealth of nations.”¹⁵ Here he conceived of wealth both as a stock of income-producing human and non-human capital *and* as a stream of real income. Smith was of the opinion that a study of wealth must (a) provide an explanation of the sources and characteristics of the two types of wealth and (b) contain a description of those individuals and institutions that are the recipients of real income. Hence he provided the following extended definition of his discipline: “Political oeconomy ... proposes two distinct objects; first to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or the commonwealth with a revenue sufficient for the public services. It proposes to enrich both the people and the sovereign.”¹⁶

To Smith, the cause of economic growth and development was the “improvement in the productive powers of labour.” Furthermore, increases in labor productivity were “the effects of the division of labour.”¹⁷ The division of labor results in greater specialization, which enhances efficiency and productivity:

This great increase of the quantity of work, which, in consequence of the division of labour, the same number of people are capable of performing, is owing to three different circumstances; first to the increase of dexterity in every particular workman; second to the saving of the time which is commonly lost in passing from one species of work to another; and lastly, to the invention of a great number of machines which facilitate and abridge labour, and enable one man to do the work of many.¹⁸

Smith argued that the aspect of specialization that affects labor productivity the most is the substitution of machinery for labor. He pointed out, for example, that when the workers in a pin factory were “accommodated with the necessary machinery,” the resultant division of labor and specialization increased each worker’s daily output from “twenty” pins to “four thousand eight hundred pins a day.” Similarly, in his discussion of the production of a wool coat, Smith pointed out that the introduction of machines was instrumental in molding the specialized skills of the “sorter of the wool, the wool-comber or carder, the dyer, the scribbler, the spinner, the weaver, the fuller, the dresser, with many others,”¹⁹ and in replacing some workers.²⁰

In explaining how technology-fueled growth and development might come about, Smith pointed out that this evolutionary process was caused by a unique interaction between invention and innovation. He described each of these activities, which he viewed as being performed by specialized agents, in some detail. In so doing, he argued that inventors provide the hardware that is innovated by “undertakers,”²¹ Smith’s term for entrepreneurs. Hence we turn first to Smith’s discussion of invention.

IV. SMITH ON INVENTION

Exogenous and Endogenous Invention

Smith commenced his inquiry into the nature and processes of invention by observing that we “have not nor cannot have any complete history of the invention of machines, because most of them are at first imperfect, and receive gradual improvements and increase of powers from those who use them.” He speculated conjecturally that it “was probably a farmer who made the original plow.” Similarly, some “miserable slave who had perhaps been employed for a long time in grinding corn between two stones probably first found out the method of supporting the upper stone by a spindle.” Subsequently, a “[millwright] perhaps found out the way of turning the spindle with the hand.”²²

Smith was of the opinion that a similar evolution occurred in manufacturing. Thus he observed that a “great part of the machines made use of in those manufactures in which labour is most subdivided, were originally the inventions of common workmen, who, being each of them employed in some very simple operation, naturally turned their thoughts towards finding out easier and readier methods of performing it.”²³ When Smith began his search for the sources of economic growth and development, such work-related, or *endogenous*, inventions were being phased out in favor of inventions that occurred outside, or separate from, the work process. Smith described these *exogenous* inventions in the following manner:

All the improvements in machinery, however, have by no means been the inventions of those who had occasion to use the machines. Many improvements have been made by the ingenuity of the makers of the machines, when to make them became the business of a peculiar trade; and some by that of those who are called philosophers or men of speculation, whose trade it is, not to do any thing, but to observe every thing; and who, upon that account, are often capable of combining together the powers of the most distant and dissimilar objects.²⁴

Thus like Clarence Ayres, a twentieth-century American institutionalist, Smith argued that all inventions “result from the invention of previously existing tools ... and devices so as to form new tools ... and devices.”²⁵ He labeled the person who makes such a combination *exogenously* a “philosopher,” usually with a background as a scientist, technologist, or engineer.²⁶

As Smith saw it, makers of exogenous inventions were set apart from the rest of society by virtue of their “education” and the “habits” and “customs” that they acquired on the path leading to their emergence as inventive technicians. As these philosopher-technicians specialize, “[e]ach individual becomes more expert in his peculiar branch, more work is done upon the whole, and the quantity of science [and inventions] is considerably increased by it.”²⁷

The Decline of Endogenous Innovation and the Alienation of Labor

During his lifetime, Smith observed the number of exogenous inventions increasing while endogenous inventions became less frequent. Smith identified two major causes of the substitution of exogenous inventions for endogenous inventions. The former type of inventions rose to prominence because of increased educational opportunities for a growing number of potential inventive technicians. Endogenous inventions dwindled because

of a decline of the inventive capabilities of workers. The following (one of his most famous comments) is Smith's description of the latter phenomenon, which he saw as one of the consequences of the increased division of labor that occurred in the wake of growing application of machine technology in manufacturing.

In the progress of the division of labour, the employment of the far greater part of those who live by labour, that is, of the great body of the people, comes to be confined to a few very simple operations; frequently to one or two. But the understandings of the greater part of men are necessarily formed by their ordinary employments. The man whose whole life is spent in performing a few simple operations, which the effects too are ... always the same ... has no occasion to exert his understanding, or to *exercise his invention in finding out expedients for removing difficulties which never occur*. He naturally loses, therefore, the habits of such exertion, and generally becomes as stupid and ignorant as it is possible for a human creature to become. ... His dexterity at his own peculiar trade seems, in this manner, to be acquired at the expense of his intellectual, social, and martial virtues.²⁸ [emphasis added]

Moreover, "the division of labour, having reduced all trades to very simple operations, affords an opportunity of employing children very young." This, in conjunction with the fact that their "parents can scarce afford to maintain them," means that the youngsters' "education is greatly neglected." As soon "as they are able to work, they must apply to some trade by which they can earn their subsistence" by performing a few simple operations.²⁹ Hence the minds of the children become just as torpid as those of their parents. When the members of each cohort of children reach maturity and become parents, the same fate will await their offspring and so on to following generations.

One can clearly observe the contradiction Smith sees in specialization and mechanization. On the one hand, specialization is instrumental in the expansion of productivity that will hopefully improve the standard of living of the poor. On the other hand, specialization has some obvious, negative effects on workers and their families—the "alienation" of the worker that, as we will show in the following chapter, Marx would later take up in depth in his analysis of capitalism. Although Smith never entirely resolved this contradiction, as will be discussed in the section on economic policy, he hinted at the possibility that endogenous inventions might be revived as a byproduct of an expansion of public education, which might resurrect the role of the laborer in the manufacturing process.

Smith noted that the environment in which potential inventive philosophers were reared was different from those of working-class youth. The potential inventors were born to families of “some rank and fortune” who were able to provide their offspring with the best education available to their class. Being properly educated, the budding inventors were in a position to acquire and apply the technological knowledge necessary for an exogenous invention, and they found ample opportunity to apply this knowledge: “The understandings of those who are engaged in such employments can seldom grow torpid for want of exercise.”³⁰ Hence Smith believed that a critical mass of inventions would soon come about because “[m]ore heads are occupied in inventing the most proper machinery” than ever before. As a result, “a variety of new machines [has] come to be invented for facilitating and abridging labor.” This augured well for the future, Smith thought, because the invention of more machines would spawn even “more ... to be invented.”³¹

Smith was fully aware, however, that in and by itself, an invention has no economic effect. An invention will be economically effective only if it is applied and used in productive processes, what the economist Joseph Schumpeter called “innovation.” This process requires not just inventive workers or technicians or even philosophers of invention, but also entrepreneurs who will risk capital trying to realize the economic promise of an invention.³² Smith was convinced, however, that if innovation was to flourish, it required an economic order whose institutions encouraged, even impelled, undertakers to innovate. Hence, before we can look more carefully at Smith’s analysis of the process of innovation, we first need to consider his pronouncements on economic policy, competition, and incentives.

V. SMITH ON ECONOMIC POLICY

Smith’s Critique of Mercantilist Policies

Smith postulated that the past and present were characterized by a “slow progress of opulence,” or wealth. He believed that growth was slow due to the stifling of inventions by the unfavorable mercantilist policies of the day.³³

Under mercantilism, the economic system in place when Smith penned the *Wealth of Nations*, the king and a handful of huge, monopolistic trading companies controlled the economy. The term “mercantilism” came from the merchants who founded these great trading companies and from the policies established by monarchs to promote economic growth by aiding the merchants to corner domestic and international markets. According to Smith, the basic fallacy of mercantilism, in which all its mistaken policies were rooted,

was the postulate that “wealth consists in money, or in gold and silver.”³⁴ Instead, he argued that true wealth is “what money purchases, and [money] is valuable only for purchasing.”³⁵

Under mercantilism, the attainment of a so-called favorable balance of trade became the overarching policy doctrine in countries devoid of gold or silver mines. As he put it, “those metals could be brought into a country which had no mines such as the United Kingdom, only by the balance of trade, or by exporting to a greater value than it imported.” Mercantilism’s “two great engines for enriching the country, therefore, were restraint upon importation, and encouragement to exportation.” The former “consisted sometimes in high duties, and sometimes in absolute prohibition.” Export, on the other hand, was stimulated sometimes by bounties [subsidies],³⁶ sometimes by advantageous treaties of commerce with foreign states, and sometimes by the establishment of colonies in distant countries.³⁷

According to Smith, this mistaken commercial policy, designed to increase the nation’s stock of money rather than its productive power, was only one feature of mercantilism that prevented the economy from increasing the real incomes of the working poor. Smith identified “regulation” of business enterprises as another tool of mercantilist policy that retarded the growth of wealth and well-being.³⁸

For one thing, the government had devised regulations that encouraged business people to collude. As much as Smith is made out by his contemporary admirers to celebrate business owners, he was deeply distrustful of their motives. Smith put it thus:

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which . . . could be executed. . . . But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary.³⁹

Thus, while Smith was skeptical about the ability of government to prevent such collusion, he certainly did not think the government should be in the business of promoting such combinations. Yet this was precisely what the mercantilist governments had done. They enacted regulations that required all those engaged in the same trade in a particular town to register with the government, thereby facilitating collusion by directly connecting everyone engaged in that trade.⁴⁰ Ostensibly, this regulation was issued in order to enable a

state to collect taxes from businessmen “to provide for their poor, their sick, their widows and orphans.” Smith argued that the majority of a chartered assembly could “enact a by-law with proper penalties, which will limit the competition more durably than any voluntary combination whatever.” The chartered assemblies, or trade associations, functioned not only as “enlarged monopolies” in each commodity market, but also as monopsonies in the purchase of labor in local labor markets.⁴¹ According to Smith, employers were “always and everywhere in a . . . constant and uniform combination, not to raise the wages of labour above their actual rate. . . Masters too sometimes enter into particular combinations to sink the wages of labour even below this rate.”⁴²

Here we can observe Smith’s nascent theory of class conflict, developed and extended significantly by Marx, based on the fundamental premise that the interests of owners are often in opposition to the interests of workers. Smith believed that the inequality generated by an unfair economic system had the potential of erupting into open conflict.

Wherever there is great property, there is great inequality. For one very rich man, there must be at least five hundred poor, and the affluence of the few supposes the indigence of many. The affluence of the rich excites the indignation of the poor, who are often driven by want and prompted by envy to invade his possessions. It is only under the shelter of the civil magistrate that the owner of that valuable property . . . can sleep a single night in security.⁴³

Smith also censured the government for granting individual business owners special privileges, including monopolies on the production and, sometimes, exportation of a particular commodity. He likewise denounced the “statutes of apprenticeship” and the “law of settlements.” The former required that no person could work in any trade or craft “unless he had previously served to it an apprenticeship of seven years.” The laws of settlements forbade every “poor workman, when thrown out of employment either in one trade or in one place,” from seeking “for it in another trade or another place.” If he nevertheless should do so, he would suffer prosecution or removal from his new employment.⁴⁴ Smith condemned both sets of statutes for two reasons. In the first place, they “restrain[ed], in particular employments, the competition . . . [that] might otherwise go into them.” Hence the regulations strengthened the power of employers. Second and, in Smith’s opinion, of greater importance, the statutes were “real encroachments upon natural liberty.”⁴⁵

In Smith’s opinion, the regulation of foreign trade and the granting of monopolistic power to business enterprises were intimately connected and

intertwined parts of mercantilism. The foreign-trade policies were measures designed to accommodate the business community's hunger for money. By granting monopolistic power to enterprises and trade associations, the businessmen could charge exorbitant prices for goods sold at home and abroad. As Smith put it, the "price of monopoly is upon every occasion the highest which can be got."⁴⁶

Smith had no doubt that the real engineers of mercantilism were, in fact, the huge firms that dominated and controlled the economy and the government:

[T]he monopoly which our manufacturers have obtained against us ... [has] become formidable to the government, and upon many occasions intimidate[s] the legislature. The member of parliament who supports every proposal for strengthening this monopoly, is sure to acquire not only the reputation of understanding trade, but great popularity and influence with an order of men whose numbers and wealth render them of great importance. If he opposes them, on the contrary, and still more if he has authority enough to be able to thwart them, neither the most acknowledged probity, nor the highest rank, nor the greatest public service can protect him from the most infamous abuse and detraction, from personal insults, nor sometimes from real danger, arising from the insolent outrage of furious and disappointed monopolists.⁴⁷

Smith admonished that the "proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution ... [because it] comes from an order of men ... who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it."⁴⁸

Smith was convinced that the mercantilist regulations were instigated by the state at the behest of powerful business interests. "That it was the spirit of monopoly which originally both invented and propagated this doctrine, cannot be doubted"; in other words, the government's economic policies were "always directed ... by the clamorous importunity [or pressure] of partial interests."⁴⁹ Smith was therefore of the opinion that the state and its institutions were corrupt because legislators, administrators, and justices were obedient and servile lackeys of actual and would-be monopolists.⁵⁰ He thundered: "[we should] break down the exclusive privileges of [firms and] corporations [i.e., trade associations], and repeal the statute of apprenticeship ... and add to this the repeal of the law of settlements"; in short, rescind "all those laws which restrain ... competition." Smith hoped that true (perfect, atomistic) competition between firms in product and labor markets would

lead to better products, greater productivity, lower prices, and higher wages. Smith was confident that once the “sovereign [i. e., the government] is completely discharged from ... the duty of superintending the industry [i.e., industriousness] of private people, the obvious and simple system of natural liberty establishes itself on its own accord.”⁵¹ Smith was, perhaps, overly optimistic here about the possibility of a system of natural liberty establishing and regulating itself without the oversight of a government safeguarding the welfare of workers and consumers. *Laissez-faire* has seldom operated in the idyllic fashion that Smith hoped it would, a topic taken up in greater detail in the next chapter on Marx.

The Proper Role of Government in Adam Smith’s System

It is important to note that Smith did not equate natural liberty with raw *laissez-faire*. He was too much of a humanitarian to fall into that trap. The government had to serve some public functions and to endow the private sector with a human face, to use a term that has been tossed around by some present-day politicians. “According to the system of natural liberty,” said Smith, “the sovereign has ... to attend to ... three duties of great importance.”⁵² He enumerated these as follows:

[F]irst the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice and oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it never can be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do more than repay it to a great society.⁵³

The first of government’s functions, to provide for the common defense, is clear enough and rarely contested as a general principle. However, the second and third functions of government are not so clearly understood or readily accepted. As far as justice is concerned, Smith was ready to entrust the government with a monopoly on its administration because in the absence of such a monopoly, “civil society may ... be a Scene of Bloodshed and disorder every man revenging himself at his own hand whenever he fancies himself injured.” In other words, society “cannot subsist among those who are at all times ready to hurt and injure one another.” As Smith saw it, the

government's administration of justice is, therefore, "the main pillar that upholds the whole [social] edifice."⁵⁴ How the administration of justice can avoid the problems that plagued mercantilist governments—special interest influence and unequal treatment under the law—is not clear. Regarding public goods, Smith contended that government should provide, maintain and operate certain unprofitable institutions (public goods), which made him an advocate of limited *laissez-faire*. He divided such institutions into "those facilitating the commerce of the society, and those for promoting the instruction of the people."⁵⁵

In the first category, Smith included the construction and "maintenance of the public works which facilitate the commerce of any country, such as good roads, bridges, navigable canals, harbours, etc." He observed that the objective of this kind of public works was "to facilitate commerce in general." Also, the government should establish institutions and provide facilities for the benefit of "particular branches of commerce, which ... require extraordinary protection,"⁵⁶ that is, import duties to protect key sectors from foreign competition. Here Smith acknowledges the need for government to insure trade is free and fair in certain markets.⁵⁷

Smith defended his proposal for this first category of public goods, government construction and operation of unprofitable domestic infrastructure institutions, on the grounds that they would enable business firms to spawn welfare-generating economic activities. Hence this particular recommendation is in harmony with his desire to contribute to the emergence of a system of limited *laissez-faire*.⁵⁸ However, his defense of import protection might benefit some of the "enlarged monopolies." So why did he take this apparently non-Smithian approach? He gave two reasons. One is a rather sheepish argument to the effect that the "protection of trade ... has always been considered as essential to the defence of the commonwealth, and upon that account, a necessary part of the duty of the executive power."⁵⁹ His second justification is more in line with his humanitarian inclinations. "Humanity may ... require," said he, that "natural liberty" and "freedom of trade should be restored only by slow gradations, and with a good deal of reserve and circumspection." If all government restrictions on imports, the various state grants of monopoly power, and the executive's protection of businesses overseas were "taken away all at once," chaos would surely follow. Such an act would "deprive all at once many thousands of our people of their ordinary employment and means of subsistence."⁶⁰ The persons who would lose their meager level of living by such a revolutionary change were precisely those laboring poor whose welfare Smith wished to see improved manifold through the

adoption by government of his proposed scheme for the institution of limited *laissez-faire*. In other words, Smith recommended a step-by-step dismantling of the institutions of the mercantilist state that so favored monopolies. Neoliberal shock therapy (to use the modern phrase for drastic, free-market reforms) would be too devastating to the fabric of society.

In addition to government provision of infrastructure, Smith advocated a second category of public goods: expansion of public education. If inventions were to occur at a sufficient rate by suitably talented people *and* if the inventions were to be operated by technologically adequate operatives, it would be necessary for society to make much greater investments in human capital than was done under the regime of mercantilism. Thus, Smith hoped to stimulate exogenous invention by “philosophers” and to improve the education of the typical worker enough to spark a renewed increase in endogenous innovation from the workforce. For perhaps the first time in the history of economics, Smith described the importance of investments in *human* capital:

When any expensive machine is erected, the extraordinary work to be performed by it before it is worn out, it must be expected, will replace the capital laid out upon it, with at least the ordinary profits. A man educated at the expense of much labour and time to any of those employments which require extraordinary dexterity and skill, may be compared to one of those expensive machines. The work which he learns to perform, it must be expected, over and above the usual wages of common labour, will replace to him the whole expense of his education, with at least the ordinary profits of an equally valuable capital.⁶¹

In Smith’s view, therefore, part of the nation’s fixed capital consisted of

the acquired and useful abilities of all the inhabitants or members of the society. The acquisition of such talents, by the maintenance of the acquirer during his education, study, or apprenticeship, always costs a real expence, which is a capital *fixed and realized . . . in his person*. Those talents, as they make part of his fortune, so do they likewise of that of the *society* to which he belongs. The improved dexterity of a workman may be considered in the same light as a machine or instrument of trade which facilitates and abridges labour, and which, though it costs a certain expence, repays that expence with a profit.⁶² [emphasis added]

As with infrastructure, education creates spillover (external) benefits for society as a whole, and should be provided at a higher level than would be supplied by the private sector.

As Smith saw it, the principal form of investment in human capital consists of two intertwined activities or procedures. One consists of public outlays for the production of the social good of education. As explained by Smith in the passages quoted above, the other one involves the expenditures on life-sustaining resources by students during the period in which they are being educated, plus, Smith might have added, their foregone incomes during that period.

Smith recommended that the education of the young be made the responsibility of the government on behalf of society at large. The ignorance and stupidity created by the division of labor and specialization, Smith believed, would continue to be the hallmark of “the labouring poor ... unless government takes some pains to prevent it.” Hence “some attention of government is necessary in order to prevent the almost entire corruption and degeneracy of the great body of the people.”⁶³ In view of this, Smith recommended that the “public ... facilitate ... [and] encourage ... even impose upon almost the whole body of the people, the necessity of acquiring those most essential parts of education,” which he identified as the ability “to read, write, and account.” And, said Smith, the “public can facilitate this acquisition by establishing in every parish or district a little school, where children may be taught” these essentials. As part and parcel of his concept of harnessed *laissez-faire*, Smith opined that the “public can impose upon almost the whole body of the people the necessity of acquiring those most essential parts of education, by obliging every man to undergo an examination or probation in them before he ... be allowed to set up any trade either in a village or town corporate.”⁶⁴ Thus education of young males⁶⁵ had two purposes, according to Smith. In the first place, it was to provide potential innovators with the intellectual acumen and the knowledge and abilities that would be required for the making of innovations. Second, and of equal importance, it was to endow future working-class generations with the ability and know-how that were prerequisites for operating the new productive equipment that would be placed on factory floors by innovators. Moreover, when the operatives become thus educated, improvements of machines in the plants where they work may again emanate from the (endogenous) “inventions of common workmen.”⁶⁶ This would be an added stimulus to economic growth and development.

The Labor Theory of Value

Smith emphasized education so strongly because of his belief in the labor theory of value. Smith placed human labor at the center of the economy. It

The Invisible Hand of Markets Needs the Visible Hand of Government

In their recent book *American Amnesia*, political scientists Jacob Hacker and Paul Pierson argue that the “modern partnership between markets and governments may well be humanity’s most positive-sum bargain (making both sides better off)” (Jacob Hacker and Paul Pierson, p. 2). In their examination of the sources of American economic success, they find that government support of such important public goods as research and development, education (both K-12 and higher education), and economic and physical infrastructure, were key to American economic success during the 20th century. Drawing upon the American example, they conclude that it has not been solely capitalist institutions that have produced tremendous economic growth and, in turn, increased the material standard of living for most of the world’s inhabitants over the past two centuries; it has also been the “modern machinery of economic statecraft” (p. 8).

And yet, despite the achievements of the mixed economy—Adam Smith’s essential vision, which assigns a significant role to government alongside markets—government’s role in the economy has been under assault for the past several decades. This attack, according to Hacker and Pierson, has included several elements: a rhetorical assault by key economists and pundits describing government as “inefficient and wasteful” (p. 169), a new cohort of “political entrepreneurs [who recognized] that stoking antigovernment sentiments was a winning strategy” (p. 195); and the emergence of a “superconservative superwealthy” (p. 237)—most famously, the Koch brothers—who have had the political access and clout to bend key regulatory and tax policies to their benefit, while at the same time discrediting any government policies with which they disagree.

As we discussed earlier in this chapter, Adam Smith wrote the *Wealth of Nations* in large part to decry the political influence of the mercantilists of 18th-century Britain. But he was not so naïve as to ignore the possibility that the simple system of “natural liberty” that he proposed would suffice to prevent future monied interests from exerting their clout within future versions of market capitalism. Indeed, as Hacker and Pierson note, Smith remained concerned that new powerful economic interests might emerge to skew the mechanisms of government to be “overly beholden to [their] narrow private interests” (p. 5) rather than to the broad public interest.

Hacker and Pierson have written their book to remind us that democratic institutions remain essential to making market capitalism work for all. This is not to deny that government has become “more dysfunctional ... and more beholden to narrow and deep-pocketed interests” (p. 366) in recent decades, in part because of the emergence of the very monied interests that have subverted the public interest. But the solution is not to retreat to a *laissez-faire* economy, nor to accede to a government of the wealthy, by the wealthy, for the wealthy. It is, in the words of Hacker and Pierson, to fight for a government “that effectively promotes human flourishing” (p. 369).

is human beings who produce the nation's output and are the only value-generating factor of production. Smith stated this proposition in the opening sentence of the first chapter of the *Wealth of Nations*:

The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consists always, either in the immediate produce of that labour, or in what is purchased with that produce from other nations.⁶⁷

The labor that Smith had in mind was the “productive” labor of all the participants in the productive process from beginning to finish: inventors, innovators, undertakers, and ordinary workers. The labor of each of these actors in the economic drama “fixes and realizes itself in some particular subject or vendible commodity, which lasts for some time at least after that labour is past. It is, as it were, a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion.”⁶⁸ Thus Smith developed and employed what may be called a “labor-embodied” theory of production—a commodity’s value is determined by the amount of labor it embodies. John Maynard Keynes was almost alone among economists to appreciate this central aspect of Smith’s economics. Keynes put it in this way: “I sympathise ... with the ... classical doctrine that everything is *produced by labour*.... It is preferable to regard labour, including, of course, the personal services of the entrepreneur and his assistants, as the sole factor of production.”⁶⁹ As we shall see in the next chapter, Marx disagreed with the notion that the capitalist could be treated as just another laborer because, to Marx, capitalists profited from what they forced laborers to do, not from what they worked to produce themselves.

In the terms of his labor-embodied theory of value, Smith argued that the “value of any commodity ... to the person who possesses it, and who means ... to exchange it for other commodities, is equal to the quantity of labour which it enables him to purchase or command. Labour, therefore, is the real measure of the exchangeable value of all commodities.”⁷⁰ Although Smith switched here to a labor-command theory of value—the value of a commodity is determined by the amount of labor it takes to purchase that commodity—it is clear that labor is the factor that determines exchange value in Smith’s system of limited *laissez-faire*. He realized, of course, that money serves as an intermediary in the buying and selling of commodities. Despite the fact that the “real price” of a commodity exists in the labor-containing “quantity of the necessaries and conveniences of life which are given for it;

its nominal price, [consists] in the quantity of money” which is actually paid for it. Smith argued that the money price of an article tends to reflect its real price in terms of the quantity of another labor-embodied commodity that it would fetch in the market place. That is, the money prices of articles are “adjusted ... by the higgling and bargaining of the market” in such a fashion that these nominal prices become truly representative of the labor-determined ratios at which the commodities exchange.⁷¹ In other words, the prices generated by the forces of supply and demand reflect the value of labor contained within each good. To Smith, labor was the primary factor creating value and determining prices in an economy, and education to increase the productivity of labor was therefore a key public institution in promoting economic growth and the general welfare.

The Invisible Hand and the Consequences of a System of Limited *Laissez-Faire*

Smith concluded his discussion of the role of public institutions in the economy with this reiteration: “The expense of maintaining good roads and communications is, no doubt, beneficial to the whole society, and may, therefore, without any injustice, be defrayed by the general contribution of the whole society” in the form of taxes and other levies for the government’s use in financing the erection and maintenance of public works. “The expense of the institutions for education ... is likewise, no doubt, beneficial to the whole society, and may, therefore, without injustice, be defrayed by the general contributions of the whole society.”⁷²

Once Smith’s proposed system of limited *laissez-faire* is fully established as a going concern, every “man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest in his own way, and to bring both his industry [i.e., industriousness] and capital into competition with those of any other man, or order of men.” Thus “competition will immediately” become the sole mechanism for the formation of commodity prices, wages, and other charges. And, the “price of free competition ... is the lowest which can be taken.” Smith did not view competition as a condition in which a seller, or supplier, passively adjusts his output, or supply, in response to changing price signals emanating from the relevant market, as implied by the supply and demand model of mainstream economics. On the contrary, Smith’s concept of competition was one of active rivalry, or “rivalship of competition,” as he put it.⁷³ For example, in manufacturing and commerce, the undertakers are “rivals” who strive to “supplant” each other. They do so by several methods: bids, counter-bids, and “under-selling.” This

type of “competition . . . is advantageous to the great body of the people” because of the resultant minimal prices that are generated dynamically in a process of growth.⁷⁴ Although each individual undertaker “intends only his own gain,” he is led by the “invisible hand [of competition] to promote an end which was no part of his intention.” In other words, the driving force of “self-love,” or self-interest, is transmuted wondrously into social welfare for the masses.⁷⁵

Morals, Competition, and Justice as Regulators of *Laissez-Faire*

To Smith, competition was not always enough to insure that self-interest operated in the best interests of all. Smith also saw the need for a sound moral basis in society. In terms of self-interest, Smith noted that people were not entirely selfish and that they do (and should) care for others. Indeed, Smith began his first famous book, *The Theory of Moral Sentiments*, with the following statement: “How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him.”⁷⁶ Smith wrote extensively on the social framework and moral basis necessary to make the market system work. As Jerry Evensky observed in his commentary on ethics and early economic liberalism, “Only in a community of ethical individuals can the invisible hand do its job properly, for it is ethics that keeps the hands of individuals from disabling, and thus distorting the actions of, the invisible hand. In the absence of such an ethical community, competition becomes destructive. In Smith’s master metaphor, it is ethics that stands between a beneficent society and the Hobbesian abyss.”⁷⁷ Similarly, as noted earlier, Smith emphasized that a system of justice is also a requirement for the invisible hand to function appropriately. In other words, Smith argued that it is *only with competition, justice, and moral sentiments that self-interest would operate in such a way as to promote the general welfare of society.*

The degree to which markets today actually operate to promote the general welfare of society is open to debate. For example, in the above passages, Smith seems to assume that markets would *always* be sufficiently competitive to generate low prices, new innovations, and enough competition for labor such that workers would be treated well and paid fairly. Smith hoped that greed, tempered by moral sentiments, competition, and a system of justice, would invariably serve the interests of humanity. As we shall see in the other chapters in this book, Karl Marx and many other political economists disagree with these assumptions about the functioning of a *laissez-faire* system and greed. It is also important to recognize that Smith made his argument for

limited *laissez-faire* in the context of a critique of mercantilism, in which the state was used on behalf of special interests. Smith did not consider the possibility of a state working on behalf of its citizens to guide the market system. So while Smith opposed government intervention in the form of *mercantilism*, it is unclear whether he would support modern forms of government intervention in the marketplace. Anti-trust laws to preserve competition, regulations to prevent abuse of the environment, labor laws to protect workers, product safety laws to protect consumers, and the expansion of public investment in the economy are but a few of the areas in which modern governments interfere with the market system. But these laws do not necessarily depart from Smith's beliefs in competition, the centrality of moral sentiments, and the provision of public goods with spillover benefits.

Nevertheless, although he had never observed such a system in practice, Smith believed that a system of natural liberty, or harnessed *laissez-faire* with rivalrous competition, is the proper economic environment for the virtuous entrepreneurial activity of growth-promoting and development-fostering innovation.⁷⁸ In fact, Smith thought the market system would be so innovative that economic growth would render any flaws in the market system irrelevant. We now turn to Smith's analysis of innovation, the key to the market system functioning in the manner he hoped.

VI. SMITH ON INNOVATION

Smith believed that, in the unregulated markets of the just society, each profit-seeking undertaker is forced by the ubiquitous invisible hand unintentionally to "render the annual revenue of the society as great as he can."⁷⁹ In theory, if undertakers are not as productive as possible, they will be supplanted by rivals. This assumes, of course, that undertakers cannot collude with rivals or rig markets in their favor and thereby profit without being productive, an activity that is rampant under capitalism (as we will see in later chapters on Marx, Veblen, Galbraith, and others). Smith saw three key kinds of activities in which productive undertakers engage. The first of these may be termed *revolutionary* entrepreneurial functions; the second, *imitative* entrepreneurial functions; and the third, *routine* entrepreneurial functions.

The first function is labeled revolutionary because it is the principal institutional instrument by means of which a "great revolution" is brought about in productive processes with the result that "public opulence" is greatly enhanced. The practitioners of the function are especially "daring" undertakers who are eager to take "extraordinary" risk. They run such risks when they

acquire new and untried inventions from the tribe of inventing philosophers. Typically, these inventions consist of “new machines” which promise to serve as efficient instruments “for facilitating and abridging those operations” that are executed by each of the workmen who are in the employ of the brave undertakers.⁸⁰ Once an entrepreneur has placed the acquired new innovation in operation, the abridgement of labor manifests itself in the form of “advances ... [in the] division of labour.” Consequently, the “quantity of materials which the same number of people can work up, increases in great proportion as labour comes to be more and more subdivided; and as the operations of each workman are gradually reduced to a greater degree of simplicity.” When this happens in the shop of a particularly pace-setting undertaker, the marketable output increases and the unit cost of production declines. According to Smith, in the markets characteristic of his day, where firms were very small relative to the size of the market, such an entrepreneur could supply more of his good without increasing perceptibly the total quantity brought to market by all firms, and the market price would not sink.⁸¹ With constant prices, lower unit costs and greater output, the bold undertaker’s profits increase substantially.

Capital Accumulation, Investment and Innovation

How does a bold undertaker obtain the means for the innovation of a particular new invention? Smith’s answer was: by accumulating capital. Undertakers must save a proportion of the surplus (revenues minus wages) in order to invest in new inventions. Smith emphasized that surpluses originate in profit and that profit is a “deduction from the produce of ... labour.”⁸² According to Smith:

In all arts and manufactures the greater part of the workmen stand in need of a master to advance them the materials of their work, and their wages and maintenance till it be completed. He shares in the produce of their labour, or in the value which it adds to the materials upon which it is bestowed; and in this share consists his profit.⁸³

Smith considered this extraction of labor-created profit by the undertakers to be fundamental because it made possible those entrepreneurial savings which he viewed as the first step in the process of innovation. Smith was not concerned, as Marx was, with the fact that the undertakers might have amassed their initial investments in unethical ways, nor did he object, as Marx did, to the undertaker taking some of the laborer’s output. Rather,

Smith saw the amassing of capital as a positive development. The following is Smith's eulogistic praise of saving and capital accumulation:

Parsimony, and not industry [i.e., dexterity, skills, and industriousness on the part of the agents of production], is the immediate cause of the increase of capital. Industry, indeed, provides the subject which parsimony accumulates. But whatever industry might acquire, if parsimony did not save and store up, the capital would never be the greater.⁸⁴

Without saving, no new innovations would occur, no "additional quantity of industry" would be put "into motion" and no "additional value [would be given] to the annual produce" of the nation.⁸⁵ But in a system of natural liberty, the invisible hand of competition forces profit-seeking, bold undertakers to be parsimonious so that they will have available the wherewithal for innovation when the same unseen hand impels them to be on the prowl for newly invented machines that may "enable one man [on their work force] to do the work of many." In other words, competition ensures that each pace-setting entrepreneur furnishes his workers "with the best machines which he can . . . afford to purchase." Hence such an innovator will be able to make "the most proper distribution of employment . . . among his workmen" so that they may "produce as great a quantity of work as possible."⁸⁶ Competition ensures that all firms save and invest, and that firms produce as efficiently as possible.

The process of revolutionary innovation begins with the act of saving on the part of bold undertakers and ends when they install and operate the new and superior machinery that their savings enable them to acquire from inventors. Thus, Smith conceived of the act of revolutionary innovation in terms of four operations, or processes: (1) capital accumulation (savings); (2) acquisition of inventions through the expenditure of the accumulated capital; (3) installation of the acquired inventions; and (4) start-up of the equipment in question.

These are the innovative activities in which a relatively small number of bold undertakers engage. And they do not do so in a haphazard fashion. On the contrary, they make plans and design projects in order to "regulate and direct all the most important operations of labour, and profit is the end proposed by all those plans and projects." Because of this careful planning of the employment and distribution of labor in the process of innovation and beyond, the pioneering undertakers' expectations of extraordinarily high rates of profit are validated. As each entrepreneur enlarges his scale of operations in a succession of innovations, "not only the number of profits increase, but every subsequent profit is greater than the foregoing."⁸⁷

The Role of Competition and Imitation in Limiting Incomes

In the condition of perfect liberty, and hence rivalrous competition, the relatively small number of bold undertakers in each trade cannot “long enjoy their extraordinary profits without any new rivals. Secrets of this kind ... can seldom be long kept; and the extraordinary profits can last very little longer than they are kept.”⁸⁸ Once the secrets are out, hordes of *imitating* undertakers copy the innovations of the courageous entrepreneurs. Although “timid undertaker[s]”⁸⁹ do not dare to take the risk inherent in innovation, the profits garnered by the pioneers prompt the imitators to engage in what appears to be risk-free replication of the pioneers’ innovations. Consequently, there is a substantial increase in production and supply as more and more producers copy innovations and experience increased productivity. The result is that the “quantity brought to market exceeds the effectual demand” and the “market price will sink.”

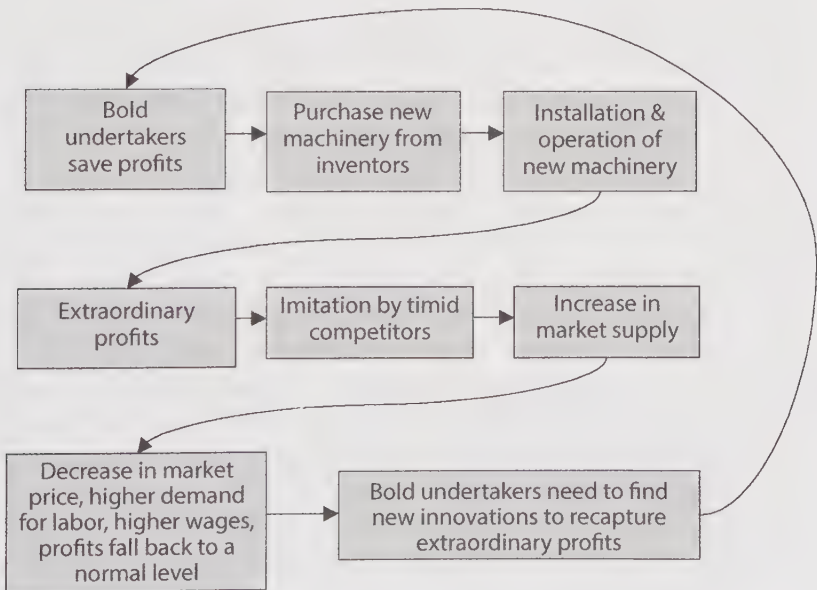
At the same time, the demand for labor is increased by the spur of activities engendered by the imitating undertakers. The result is that wages go up. At the same time, labor productivity increases due to the increase in stock of physical capital as a result of innovation and imitation. A “smaller quantity of labour [can now] produce a greater quantity of work.” Higher wages are offset by higher productivity. Thus, although *extraordinary profits* are wiped out because of the fall of the prices of output, the acceptable minimum rate of *ordinary profit* is preserved by the increase of productivity. The undertakers are therefore not tempted to withdraw part of their stock from their firms.⁹⁰ In other words, innovation and subsequent imitation increases productivity, reduces goods prices, and increases the demand for labor along with the wage rate. Bold undertakers return to earning a normal rate of profit after the imitators catch up, and the standard of living of the people improves as prices fall. Thus Smith saw competitive capitalism gradually raising the incomes of the workers and limiting the incomes of the rich.

The bold undertakers are eager to recapture their lost rates of extraordinary profits, however. Hence they engage in a new round of innovations. They are successful initially in restoring their lost rates of abnormal profit. But once again the rate of profit is soon forced down to a normal level by the imitation of timid undertakers. After an interval, the bold undertakers innovate again. Their success is once more short-lived because of the predictable responses of timid undertakers. Smith viewed this cycle as a phenomenon that would continue to characterize an economic system of limited *laissez-faire*. In the long run, the market “prices of all commodities are [therefore] continually gravitating” toward their “natural price,” which is

the minimum price that must be paid in order for the undertakers to reap the ordinary rate of profit. It means that the workers are the gainers of technological advancement through innovation and imitation. As Smith put it, the “liberal reward of labour,” and the “greatest public prosperity [is] the effect of increasing wealth.”⁹¹ To repeat: This increase in the standard of living of workers is caused by the timid undertakers’ imitations of the bold entrepreneurs’ innovations of those exogenous inventions that were made previously by technologically minded philosophers. Entrepreneurs cannot earn more than a normal profit over the long term, but the standard of living of workers steadily increases as productivity improves and goods prices fall. Smith’s depiction of the process of innovation and imitation is laid out in Figure 2.1.

In addition to innovation and imitation, undertakers perform certain *routine* entrepreneurial activities that Smith identified as “inspection and direction” of their enterprises. He observed, however, that in “many great works, almost the whole labour of this kind is committed to some principal clerk.”⁹² Consequently, the bold and the imitating entrepreneurs can concentrate their attention on the tasks of innovating and imitating, respectively.

Figure 2.1. Smith’s View of Invention and Imitation in Competitive Markets



VII. CONCLUSION

Smith's system of natural liberty is a mixed economy in which invention, innovation, and imitation in the private sector are supported, promoted, and furthered by institutions ensconced in the public sector. As mentioned above, Smith thought the dynamic interaction of the public and private sectors would result in a process of growth and development in which the members of the working class are the principal beneficiaries. He believed that is so because the institutionalized "invisible hand" of competition directs each profit-seeking undertaker to promote "an end which was no part of his intention," namely, optimal social welfare for all citizens including, for the first time in history, the working classes. "In ease of body and peace of mind, all the different ranks of life are . . . upon a level." That is so, Smith reiterated, because all profit-seekers are "led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society."⁹⁴ This was Smith's way of predicting that the institutions of modified *laissez-faire*, especially that of rivalrous competition, would in the long run effect a nearly *equal* distribution of real income. Almost alone among prominent Smith scholars, D. D. Raphael detected this radical position in Smith's work. Raphael put it in this way: Smith's invisible hand guides gain-seeking individuals "to distribute it [i. e., income] more equally, so as to approach *equality*." And Raphael added: Smith "knows very well that the effect comes about automatically through the interplay of individual interest and the system of exchange. His perception of this truth is one of his great contributions to economic understanding."⁹⁵

As Smith predicted, the limited *laissez-faire* regime adopted to varying degrees in England and other European countries in the 19th century was able to produce impressive rates of economic growth. But it did *not* yield a nearly equal distribution of income, nor did the working class tend to see most of its benefits. A principal reason for this limit in Smith's vision is that, though he saw the giant firms on the horizon of capitalism, he did not anticipate how they would replace his "limited *laissez-faire*" capitalism with a vastly more complex system. His bucolic, beneficent system would become a mammoth network of monopoly firms surrounded by a host of smaller firms that would come and go as the economy rose and fell. The new system would produce entirely different outcomes regarding wages, innovation, prices, income distribution, and the overall effects on all the participants.

Karl Marx, whose ideas we will take up next, began producing his descriptions of the laws of motion of a capitalist system about 75 years after Smith published the *Wealth of Nations*. He had great appreciation for Smith's skill in describing how a market system would work with relatively small firms, with an adequate supply of willing and able labor, and with a neutral government providing only for the national defense, justice, and public works. He also agreed with Smith in general about the labor theory of value.

But Marx, and the other writers to follow in this book, were working to understand the form of capitalism that replaced Smith's economic world. This new kind of economic system led political economists following Smith to produce a broader version of political economy, especially in adding an analysis of how the huge firms—far from being neutral—would shape the government to do their bidding. Marx would go so far as to claim that in capitalist societies, the government generally served on behalf of the business owners. We will now turn to Marx to see why he would reach such a conclusion, as well as the many others that have long captured the attention of students of market capitalism.

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3

Karl Marx and the Contradictions of Capitalism



Our goal in this chapter is to present a coherent summary of Marx's analysis of economic forces in society and how they shape human lives. We will do that in two parts. The first briefly outlines a theory of historical change that Marx developed with his long-time collaborator, Friedrich Engels. In 1845-6 the two wrote a manuscript, *The German Ideology*, that contained their explanation of historical change, called "the materialist conception of history." We will briefly

provide a structural outline of this conception of history with a few examples to help the reader learn the basic terminology of the system.

We then turn to a more lengthy examination of how Marx applied his theory of historical change to capitalism. This application is spread over thousands of pages of material that Marx and Engels wrote. However, the single most compact presentation is in *Capital*, Volume I (hereafter referred to as *Capital*), and the second part of this chapter will concentrate attention on the arguments about capitalism in that book. *Capital* is by far Marx's most thorough application of his materialist conception of history, and by presenting them in sequence we hope to clarify the "Marxian" view of capitalism. Marx's analysis of capitalism is an intricate theoretical structure, buttressed by a huge compendium of historical description, and when studied closely it can be genuinely breathtaking in its breadth and depth.

We also want readers to see the great divide between Marx's analysis of capitalism and that of most current mainstream economists, who tend to

look upon capitalism as a “given system,” and exhibit little or no professional interest in the historical process that gave rise to it. They have ripped economic analysis from its historical context, ignoring the development and evolution of the capitalist system. As we move through the Marxist view of the world we will be demonstrating the major differences between his work and that of mainstream economists.

I. THE MATERIALIST CONCEPTION OF HISTORY AND CLASS STRUGGLE

Marx and Engels began their economic analysis by making the obvious claim that in order to survive, we human beings must learn to mix our intelligence and our energy—our work—with the basic “materials” of the world we find ourselves in: its soil, water, and air. We must work with what is at hand in order to make this today into tomorrow. In 1878, Friedrich Engels described how this truism about human survival would be the basis of their materialist theory of historical change:

The materialist conception of history starts from the principle that production, and with production the exchange of its products, is the basis of every social order; that in every society that has appeared in history the distribution of the products, and with it the division of society into classes or estates, is determined by what is produced and how it is produced, and how the product is exchanged. (Engels 1975, 74)

In other words, the economic organization of human society, or the “mode of production,” as Marx called it, is the most powerful factor in determining social structure. Notably, the way society is organized to produce necessities—for example, organized into serfs and lords in feudalism, or into owners and workers in capitalist societies—constitutes the “class structure” of society. Since virtually all production involves many different people, Marx concentrated on production as a social activity and analyzed the class structure created by the organization of production.

Marx’s method of analysis is very different from that of Adam Smith, who focused on how individuals behaved within a benignly competitive capitalist society. In contrast, Marx sought to understand the forces that cause the economy to change over time. He believed that change resulted from the struggle between opposing, or “dialectical”—what we might think of as “contradictory” or competing—forces inherent in all societies. As an example, one that Marx made much of, all economic systems produce hierarchies of social classes, with a top and a bottom, and endless competition and resentment at every

level in between. These class struggles emerge in the form of wars, revolutions, democratic reform, and in other ways, and one can find them grinding away in any history book. That is, social classes are inherently contradictory—inherently opposing—forces in almost all societies, and class conflicts provoke major changes in how societies are structured.

Marx found that the social activity of production took many different forms throughout history, with stages of social organization corresponding to techniques of production. He noted that European society passed through a number of different modes of production, including primitive communalism, slavery, and feudalism, on its way to capitalism. He concluded that capitalism is simply the latest in a series of modes of production and that it, too, will yield to some other mode of production in the future.¹

In analyzing capitalism, Marx focused on what he considered the two principal social classes. On top were the capitalists, what he called the “bourgeoisie,” consisting of those who owned the machines, factories, and other necessities for production. On the bottom were the workers, or what he called the “proletariat,” who, in order to live must work for a capitalist. Thus, in his analysis of capitalism, he would pay special attention to relations between these two classes and how their inherent struggle would spur the forces of change in the system.

Below, we will discuss further this inherent struggle, but for now we will use a few numbers regarding the workers’ share of income and wealth produced by our society. These numbers explain well why there is a constant murmur of seething resentment among the working classes about their relative weakness compared to the power of the capitalists. According to the Institute for Policy Studies, the richest 10% of the U.S. population now owns about 90% of all stocks and over 90% of all bonds. The top 1% of the U.S. population has an average family income of \$1,453,100; the bottom 20% has an average income of \$24,600. Average pay in 1980 for a CEO in the United States was 42 times as great as that of the average wage owner; that ratio increased to 373 to one in 2014. Or, to think in global terms, according to Oxfam the wealth of the top 1% of the world’s population is equal to the wealth of the other 99%, and the richest 62 people in the world had as much wealth in 2016 as the poorest half of the global population.

Aside from these numbers being evidence that capitalism generates inequality, it also suggests that we are moving further and further away from an egalitarian society. The figures underscore a further crucial point about capitalism: since owning the stocks and bonds of companies means owning the “means of production,” the wealth-generating capital of the United

States is almost all owned by one tenth of the population. Thus, in order to make a living, most of the other 90% who work for wages do so either for these richest 10%, their managers, or in the public sector of the economy. Reflecting all these numbers, from the 1970s through 2013, U.S. wage earners experienced a dramatic decline in income relative to that of the owners and top managers for whom they work. For example, in 1965, the average CEO's salary was 44 times the average factory worker's wages, but by 2013 this ratio had reached *over 300 to one* (or more, depending on the source you use).

All the measures regarding wealth, income, and control over the production system are examples of what Marx meant by the inherent struggle between the two groups. They also exemplify the inherent contradictions, or dialectical pressures, within U.S. capitalism, because sustained relative declines in income for the majority of a society's population tend to produce political upheaval. The Occupy Wall Street movement that burst out in September 2011 reflected a deep anger on the part of much of the population against the plutocracy they see as having bought their way into control of both the politics and the economic activity in the United States. Occupy members often repeated the old argument that "The interests of Wall Street rarely coincide with those of Main Street," as they embodied the class conflict that Marx and Engels had begun to predict in the 1840s. These themes were echoed in Bernie Sanders' campaign for president in 2016.

Marx and Engels had summarized this idea of inherent class struggle in the following passage from *The Communist Manifesto*, written in 1848:

The history of all hitherto existing society is the history of class struggles. Freeman and slave, patrician and plebeian, lord and serf, guild-master and journeyman, in a word, oppressor and oppressed, stood in constant opposition to one another, carried on an uninterrupted, now hidden, now open fight, a fight that each time ended, either in a revolutionary re-constitution of society at large, or in the common ruin of the contending classes. (Marx and Engels 1998, 34-5)

Capitalist Production and Commodification

In describing this materialist view of social change, C. Wright Mills, a sociologist influential in the 1950s and 1960s, wrote in *The Marxists*:

Political, religious and legal institutions as well as the ideas, the images, the ideologies by means of which men [sic] understand the world in which they

live, their place within it, and themselves—all these are reflections of the economic basis of society. (Mills 1962, 82)

The extent to which political institutions in capitalist countries reflect the needs of the capitalist class can hardly be lost on any person living in the United States today, where it seems that government at every level is for sale to the highest capitalist bidder. Less obvious, but also important, is the symbiosis between religion and the emergence of capitalism in Europe. Religious beliefs in hunter-gatherer societies usually emphasize the importance of nature and the role of people within it, and this reflects the importance of the natural environment to survival in that mode of production. Marx was struck by how convenient the teachings of the early protestant denominations were to the emergence of capitalism. These new denominations, which developed after Martin Luther's 16th-century revolt against Catholicism, stressed that one should accept one's lot in life and that all would be better in the hereafter. Such a belief, of course, made people more willing to accept the dislocations and deprivations so many experienced in early capitalism. In one of his more memorable phrases, Marx described religion as the "opiate of the masses" because he believed that workers in early capitalist societies had, quite understandably, adopted religious beliefs as the only hope in an inexorably grim world. As you can see in the sidebar on hegemony (pp. 60-62), the ability of the capitalist class to shape the ideology of a capitalist society is a crucial means by which they perpetuate their control.

Marx also argued that what he called the "cash nexus" of capitalism would eventually demean and devalue all that it pulled under its spreading wings. In 1846, in *On the Jewish Question*, he noted that money could transform all things, until money itself was all that was important in life:

Money abases all the gods of mankind and changes them into commodities. Money is the universal and self-sufficient value of all things. It has, therefore, deprived the whole world, both the human world and nature, of their own proper value. Money is the alienated essence of man's work and existence; this essence dominates him and he worships it. (Marx and Engels 1978, 50)

In Marxist language, alienation derives primarily from a process called "commodification." Everything—flesh and blood, inanimate objects, music, poetry, *everything*—is ultimately "for sale" in the capitalist marketplace. We all know countless examples of commodification. Each Christmas, to suggest an obvious one, most of us in Christian countries celebrate the birth of Jesus with

an avaricious, competitive, often depressing orgy of consumption of mostly unnecessary products. What was once a simple affair of gift giving to exemplify Christian charity has become in advanced capitalism a gruesome distortion of the original idea. Capitalism, as we all know, incessantly works on all of us to buy things we don't need. However, what another famous critic of capitalism, Thorsten Veblen, called "the sales effort" is unleashed with a special fury at Christmastime. By the time it is over, a substantial minority of us need anti-depressants as an antidote to the lack of Christmas joy that millions of advertisements told us the gifts, the cards, and the Christmas tree would bring.

Creative output of all kinds is also systematically commodified in capitalist societies, co-opted and transformed by pop culture or the advertising industry. For example, in the 1980s, Paul McCartney of the Beatles tried to

Marx, Gramsci, and Cultural Hegemony

In his essay "The German Ideology" (1845–6), Karl Marx observed that those who control the economic system can also exert a certain amount of ideological control over the rest of society. As he put it, "The ideas of the ruling class are in every epoch the ruling ideas; i.e., the class which is the ruling material force of society, is at the same time its ruling intellectual force. The class which has the means of material production at its disposal, has control at the same time over the means of mental production" This idea was refined by an Italian Marxist named Antonio Gramsci, who further developed the theory of *cultural hegemony*. Gramsci noted that the ruling class worked to manipulate the values and social mores of society so that their views became the dominant world views of society. In this way, those who control the economy can win the consent of the governed, even though the capitalist economic system primarily serves the interests of the capitalist class.

If we look around us, we see numerous examples of the capitalist class trying to manipulate the views of the working class. Consider the following examples of policies that are very favorable to the capitalist class but not favorable to workers, and how business interests have promoted those policies.

- **Business Resists the Minimum Wage.** Most research studies indicate that increasing the minimum wage has little or no effect on employment. Because businesses already try to use the least possible amount of labor to serve their customers, higher wages do not generally mean that businesses will reduce the number of workers they need to hire. Thus, the primary impact of raising the minimum wage is that workers get paid more while businesses take in lower profits. To reshape public opinion in their favor, businesses have established various foundations and institutes, such as the Employment Policies Institute, whose primary purpose is to oppose increases in the mini-

buy from a record company the rights to many of the popular songs that he had written with John Lennon. However, McCartney was outbid by another pop icon, Michael Jackson, who then proceeded to sell the rights to some of these songs to advertising firms. The Beatles song “Revolution,” written in response to the political turmoil of the 1960s, was put in the service of selling sneakers. Some Beatles fans might call this sacrilege, but to a Marxist this kind of commodification is the predictable outcome for cultural products in capitalism. “Public” radio stations that increasingly depend upon corporate funds to stay alive, the “Tostitos” Fiesta Bowl, and the Nike swoosh on the uniforms of athletes and coaches at all levels of sports around the world exemplify the way in which things that were not once part of the cash nexus have become commodities.

imum wage. They publish “studies”—often cited by pro-business, anti-labor politicians—purporting to demonstrate that raising the minimum wage is harmful to workers or to small business. As a result of this misleading research and an intense lobbying effort, the United States has one of the lowest minimum wages in the developed world, and the minimum wage is not indexed to inflation.

- **Business Resists Action on Global Climate Change.** The record heat waves of 2016, and the fact that each year brings new heat records, more rapidly melting glaciers, and increasingly devastating weather events (droughts and wildfires, floods, hurricanes, typhoons, etc.), makes it clear to anyone with basic powers of observation that the climate is changing rapidly around us. All the scientific studies, and 97–99% of climate scientists, agree that climate change is a product of human-made greenhouse gases. But such a realization could be devastating to businesses based on oil and other fossil fuels, to industrial agribusiness which is responsible for 20–35% of greenhouse gas emissions, and to goods-producing companies that depend on low production and shipping costs to sell consumers mountains of products. To combat the inconvenient truth of global climate change, companies embarked on a multi-million dollar effort to discredit climate scientists and to cast doubt among the general public that climate change is happening. (This is all documented in the book and film, *Merchants of Doubt*.) This, too, has been a very successful effort, persuading vast numbers of politicians and the general public that climate change is not something we need to be concerned about. Even with evidence all around us that climate change is occurring and that the consequences are increasingly dire, 40–50% of the U.S. population does not believe climate change is a serious concern. This, of course, allows the oil companies to keep drilling away.

For Marx, the most costly form of commodification occurs when capitalists buy labor-power in labor markets. This commodity, labor-power, is—as we shall describe in detail later—the irreplaceable element of capitalist production, because without hired laborers to produce the output capitalism cannot exist. Even in this age of high technology, labor costs still make up roughly two-thirds of the costs of production for firms, indicating how essential labor remains in the production process. When a capitalist buys labor-power, however, he or she must treat that labor-power like any other input; it must be bought as cheaply as possible and drained of its last ounce of usefulness for profit-making. The fact that labor-power is brought to the market by a human being greatly com-

- **Business Pushes Neoliberalism.** Perhaps the single most effective case of cultural hegemony has been the selling of “neoliberalism” to the citizens of the United States and other countries as an economic approach that benefits everyone. The neoliberal philosophy claims that unregulated trade, reduced government regulation, and reduced taxes on businesses and the wealthy in the short run will eventually redound to the benefit of all. (Don’t let the name confuse you: “neoliberalism” corresponds to what is known as “conservative” economic theory and policy in the United States.) The theory behind this “trickle-down” approach is that free trade, less government regulation, and lower taxes will stimulate business investment, increasing economic growth and making everyone better off. This message is pushed relentlessly by corporate-supported think tanks, business-friendly politicians and media outlets, and even in pro-business economics classes in high schools and colleges. However, the record of neoliberal policies tells a different story than that coming from the corporate hegemon (a “hegemon” is a powerful entity, which corporations surely are in U.S. society). During the neoliberal era (from 1980 to the present), as countries have increasingly adopted neoliberal policies, workers in developing countries have fared very poorly while corporate profits have soared. And, economic growth rates in developed countries have been very low during the neoliberal era. It turns out that neoliberalism isn’t good for growth or for workers, but the rhetoric we hear, from corporations and those (in academia, media, and government) that do their bidding, tries to convince us otherwise.

As the above examples demonstrate, the capitalist class does everything in its power to persuade us that they have society’s best interests in mind, and that we should support a pro-business agenda that includes low minimum wages, lax environmental regulations, low taxes, and other pro-business policies. But a closer look at these issues reveals the corporate propaganda for what it is: a crass effort by those on top to convince all of us down below that we should accept the status quo and stop questioning the way things are.

plicates the problem for the capitalist. Human beings, unlike sheets of plywood and computer chips, have imagination, wishes, plans, and dreams, perhaps even to challenge the boss! While imagination and dreams and independence of mind can make for productive workers, such traits can also be problematic for many capitalists trying to maximize profits. What employer wants a mouthy advocate of social justice, or someone who complains about poor working conditions, mixing with all the more “reasonable” employees?

Workers are interested in many things other than their jobs. In fact, many workers hate their jobs. A 2015 Gallup poll found that 90% of workers were “not engaged” or were “actively disengaged” from their jobs. Because of this, capitalists face the complicated problem of focusing their employees’ attention on the work at hand. That is why Marx saw, and today’s Marxists see, the modern capitalist workplace, particularly in the United States, as a functioning dictatorship, where all the rules are made by the bosses and followed by all the workers who want to keep their jobs. Capitalists want ordered work from conforming, non-complaining bearers of crucial labor-power. Or, in the Marxist language, they want a particular kind of commodity, one that does certain kinds of tasks, rather than actual human beings with moods, illnesses, and needs. This process is the “commodification of labor,” a major linchpin of Marxist analysis, to which we will return.

Capitalism and Its Contradictions: Globalization

Globalization, a major social transformation now engulfing everyone, everywhere, provides a good example of the materialist conception of history, particularly its dialectical and contradictory nature. Globalization is the ultimate expression of the unregulated market system, as capitalism expands inexorably in search of new markets and cheap, desperate labor. Capitalists from all the richest industrial nations have gradually bought politicians, like they buy yachts and even islands when away from the office. An exemplary consequence is that the last major remnants of democracy in the United States have been replaced by a corporate plutocracy now living out its longtime dream to rid the world of most of the rules governing multinational corporations. The outcome, what is called “neoliberalism,” was instrumental in creating the world financial crisis beginning in 2007. Remarkably, Marx had predicted this inherent path of globalization quite clearly in the middle of the 19th century. As he put it, the capitalist will plunder the globe searching for cheap labor, and “will never want for fresh exploitable flesh and blood, and will let the dead bury their dead” (Marx and Engels 1978, 215). For capitalists, this recent outburst of globalization has been immensely profitable, as evidenced by the in-

creasing inequality of income and wealth described earlier. Cheap labor and added customers from the farthest reaches of the world have enhanced capitalists' profits.

But, right behind the move toward neoliberalism followed the dialectical consequences. One of them, in the United States and in most other developed countries, was the decline of the real wages of the working class. Indeed, real wages for U.S. wage earners are less than they were in 1972: four decades of stagnant wages! Such workers cannot easily maintain their own wage levels when capitalists put them in competition with low-wage workers in developing countries all over the globe, some making as little as 30 cents an hour. Yet, as Marx saw clearly, low wages in capitalism would mean that the system could produce more than could be sold. For instance, the collapse of the housing market wiped out trillions of dollars of the presumed wealth of working people and thus their ability and willingness to buy goods and services. Further, the declining wages of workers reduces the demand for products, leaving capitalists with surplus goods and declining investment outlets—a crisis of overproduction. Capitalists usually respond to such a crisis by laying off workers and reducing investment. And, capitalists' consumption, no matter how gaudy and selfish, can only use up a fraction of the funds they control. In this way, a lack of consumption is combined with what is called underinvestment. To compound the problem even more, in the recent crisis, the reigning capitalist countries have implemented a policy of "austerity" to encourage governments in countries on the brink of financial failure to cut back their social spending so that they can pay back the banks that brought them to ruin in the first place.

As we shall see when we read the chapter on Keynes, where there are more details on austerity, the concurrent decline in all the sectors of spending can produce such disasters as the Great Depression in the 1930s. Such a chain of events was almost exactly what Marx predicted in 1848. In the present situation, the increasing inequality generated by globalization has helped to destabilize the political institutions of many countries, where workers are increasingly rising up against low wages, rotten working conditions, and a government dominated in part by corporate criminals still on the loose.

To sum up, Marx, in his theory of history, argued that in order to survive, people must construct economic systems—modes of production—and that in all societies these modes heavily shape the way people behave. Capitalism is, of course, no exception to this rule, and we have looked at

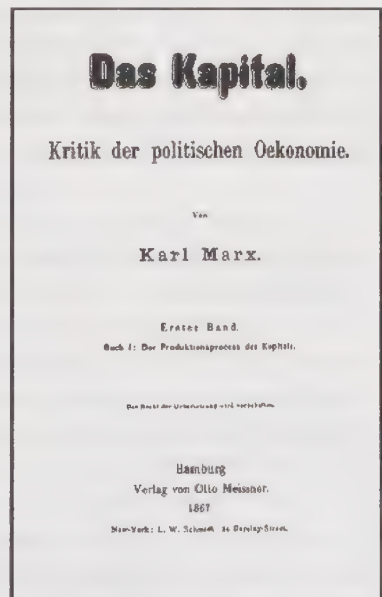
a few of the ways this system shapes our lives, especially the commodification of more and more aspects of life. And we closed with the Marxist suggestion that the sort of world economic crisis that began in 2007 is merely a precursor of worse things to come on our way to a different mode of production.

How, then, does capitalism actually work? How does it make us into what we are, and especially into commodities? We have only hinted at the answer to this question, and now we turn our attention to the broader and deeper answer developed in *Capital*.

II. MARX'S CRITIQUE OF THE CAPITALIST MODE OF PRODUCTION

After Marx and Engels developed their materialist conception of history, Marx began work on a longer project to describe and explain the “laws of motion” of capitalism. The overall structure of that explanation had been presented compactly in the first part of *The Communist Manifesto*, but its dozen or so pages gave only a fleeting glance at the complete story. The expanded version was published in 1867 in the first volume of what was to be a multi-volume project, and Marx gave it the title *Capital: A Critique of Political Economy*. The book was first published in German, and later editions in French (1872) and English (1886) made his critique available to most parts of the industrialized world. Marx was emphatic that the purpose of this book, and of all his analysis, was not just “to understand the world, but to change it.”

The first volume of *Capital* was the only one published during Marx's life. Volumes II and III were prepared by Engels from Marx's notes, and Volume IV, more a massive compendium of economic ideas than an extension of his critique, was edited by a German Marxist, Karl Kautsky, between 1905 and 1910. We will focus almost entirely on Volume I because in it, as we wrote earlier, Marx presents his most fundamental arguments about capitalism, especially the relationship between the owners/managers of capital and wage earners who work for them. By focus-



Cover of the original 1867 (German) edition

ing on *Capital*, we do not want to leave the impression that it is a compact statement of all that Marx wrote, for his other voluminous writings have been highly influential in modern thought, particularly in the social sciences and the humanities. Nonetheless, as an argument about how the production system of capitalism came to be, how it functions, and the crucial implications of those functions, *Capital* works well on its own. Its central ideas are quite easy to understand when placed in a modern context, using the experiences common to people who live in capitalist cultures. It is our purpose here to take up the major themes in Marx's critique of capitalism in precisely that kind of context. We will begin our analysis by elaborating on the principal players we alluded to above, as Marx dramatically did in his own writings.

Players on the Capitalist Field, I: Owners/Managers

We pointed out earlier that most people engaged in economic activity in the capitalist mode of production would fall into one of two major groups. First, there is the bourgeoisie, being the capitalists and their top managers. Their identifying trait is that they own or manage the capital equipment of society—the buildings, furniture, materials, and everything else needed to produce commodities (goods and services for sale). Like the classical economists before him, such as Adam Smith and David Ricardo, and the mainstream economists in our time, Marx believed capitalists have the single goal of accumulating and maximizing profits from their investments in machines, materials, and labor-power. And, like those before him, he had a high regard for the power of this capitalist accumulation process to accomplish gigantic tasks. As early as 1848, in the *Communist Manifesto*, Marx wrote:

[The capitalist class] during its rule of barely one hundred years, has created more massive and more colossal productive forces than have all preceding generations together. Subjection of nature's forces to man, machinery, application of chemistry to industry and agriculture, steam navigation, railways, electric telegraphs, clearing of whole continents for cultivating, canalization of rivers, whole populations conjured out of the ground—what earlier century had even a presentiment that such productive forces slumbered in the lap of social labour? (Marx and Engels 1998, 40-1)

Few in our own capitalist age would disagree with this claim, though others might use less florid language to make it. Marx says elsewhere in the *Manifesto* that capitalists can be depended upon constantly “to revo-

lutionize the means of production,” by which he meant that the owning-managing class will never stop imagining ways to make their production more efficient and therefore less costly. A new technique, a new revolution in the means of production, will give the individual capitalist the power to make extra profits until the inevitable occurs and competitors adopt the same technique, or perhaps even better ones. Less-industrial societies will have their “walls battered down by cheap commodities,” as Marx put it in the *Manifesto*, for no mode of production can compete with capitalism in its capacity to drive down costs and shape the world after its own image.

For Marx, when the capitalist brings together land, labor, and capital, he or she produces a volatile mix that inevitably produces conflict. This view that struggle preeminently characterizes the capitalist workplace puts him at odds with Adam Smith and most others in the classical school, and with mainstream economists. It is, of course, not lost on mainstream economists that owners often have conflicts with their workers. Yet, anything beyond a perfunctory mention of the relationship between labor and capital, or what Marx called the “social relations of production,” is left outside the province of mainstream economics. From his different perch, Marx saw market competition as compelling owners to see their workers as two-sided creatures. On the one hand, workers are crucial for production. On the other, they are unpredictable and resistant to change and authority. They are given to slowdowns if not monitored carefully, and, if united, they possess the collective power to demand higher wages and better working conditions. They can even halt production altogether by going on strike. This threat means that workers must be continually controlled, and their rebellions promptly squelched.

Marx concluded that this world of hostile workers and hungry competitors would ultimately corrupt even the most saintly capitalist. It doesn't matter whether he or she is a Christian, Muslim, or Jew; is friendly or mean-spirited; is Asian, Latin American, or what you will. Ultimately, the forces of competition can entice the most well-intentioned capitalist to reduce wages when possible, break the law, buy the politicians, adulterate the product, or even close the factory if doing so is necessary to maximize profit. Whereas mainstream economists see competition as the “invisible hand” that gives capitalism great moral authority over other economic systems, Marx saw competition as an unrelenting pressure that threatens to drag all capitalists down to the moral level of the most unscrupulous ones. As an example, Marx emphasized in *Capital* that without laws against child labor,

some capitalists will hire children if doing so will lower costs, and the advantage thereby gained will force competitors downward into a squalid moral abyss. This imperative to follow the least scrupulous competitor produces the assaults of the capitalist class on their customers, on their workers, and on the environment that one can find described daily in any newspaper.

Assessing the great power of competition to shape the actions of capitalists, Marx wrote:

To the outcry as to the physical and mental degradation, the premature death, the torture of over-work, [capital] answers: Ought these to trouble us since they increase our profits? But looking at things as a whole, all this does not, indeed, depend on the good or ill will of the individual capitalist. Free competition brings out the inherent laws of capitalist production, in the shape of external coercive laws having power over every individual capitalist. (Marx 1967, 257)

Later in *Capital*, Marx vividly exemplified these effects of competition on capitalist morality by quoting a contemporary, T. J. Dunning, who had written:

With adequate profit, capital is very bold. A certain 10% [profit] will ensure its employment anywhere; 20% certain will produce eagerness; 50%, positive audacity; 100% will make it ready to trample on all human laws; 300%, and there is not a crime at which it will scruple, nor a risk it will not run, even to the chance of its owner being hanged. (Marx 1967, 760)

Marx's description of owners differs dramatically from the mainstream version, in which the capitalist stands triumphantly on a pedestal, a heroic risk-taker who has brought together land, labor, and capital. To paraphrase Marx's parody of that version, "Mr. Capital and Mr. Labor combine with Madam Land to produce the best of all possible worlds for them all."

Players on the Capitalist Field, II: The Wage-Earning Proletariat

Beginning in his early writings, Marx assigned great importance to the oppression of the workers under capitalism. In 1844, Marx wrote a long manuscript that provided a structural overview of his thinking about "economics" at the time. The notes lay undiscovered for almost a century, yet when they were published in English in the 1950s as the *Economic and Philosophic Manuscripts*, they generated great interest among Marxist scholars, who

found a modern-sounding and compelling view about how capitalist wage labor limits human freedom.

In particular, the *1844 Manuscripts* contained a section called “Estranged Labor,” in which Marx described what, for him, were the fundamental conditions of labor under capitalism and the reasons that he found them so appalling. Marx argued that workers in capitalism are alienated from their work, their fellow employees, and themselves, and this argument became a preeminent theme for him and for all those who followed in his footsteps. According to Marx, workers’ alienation stemmed from historical processes starting in 14th-century England that gradually separated (alienated) workers from the land and tools with which they had forged a living as peasants. Eventually their survival depended on being hired as wage laborers. Marx described the terrible consequences of alienation for workers in what has become the most famous passage from “Estranged Labor”:

[Labor] is external to the worker, i.e., it does not belong to his essential being;...[I]n his work, therefore, he does not affirm himself but denies himself, does not feel content but unhappy, does not develop freely his physical and mental energy but mortifies his body and ruins his mind. The worker therefore only feels himself outside his work, and in his work feels outside himself. He is at home when he is not working, and when he is working he is not at home. His labor is therefore not voluntary, but coerced; it is forced labor. It is therefore not the satisfaction of a need; it is merely a means to satisfy needs external to it. Its alien character emerges clearly in the fact that as soon as no physical or other compulsion exists, labor is shunned like the plague. External labor, labor in which man alienates himself, is a labor of self-sacrifice, of mortification. Lastly, the external character of labor for the worker appears in the fact that it is not his own, but someone else’s, that it does not belong to him, that in it he belongs, not to himself, but to another ... it is the loss of the self. (Marx and Engels 1978, 74)

This conclusion that “lost labor” is a “lost self” perhaps says it all, yet does so in a far too general way. Fortunately, soon after writing the *1844 Manuscripts*, Marx entered into his long collaboration with Friedrich Engels, during which they turned out thousands of pages in the form of essays, books, newspaper articles, and letters about capitalism. An ongoing burden of these pages was to explain to workers the nature of the system that oppressed them and to urge them to rise up against it. What follows are the key ingredients of this explanation.

In *Capital*, Marx had a good deal to say about the causes of estranged labor, and his analysis was more in the language of classical economics and less in the philosophical language of his earlier writing. In three key chapters of the book (13-15), Marx outlined the evolution of what 19th-century economists called the “division of labor” (what we now call “specialization”). Marx saw that a central reason for the estrangement of factory labor was the fact that it was profitable for owners to break tasks down into smaller individual units of work. As production was reduced to repetitive, mindless tasks, workers suffered physical injuries and mental frustration. Marx quoted from a French economist of the time to describe the grim consequences:

To subdivide a man is to execute him, if he deserves the sentence, to assassinate him if he does not. ... The subdivision of labor is the assassination of a people. (Marx 1967, 363)

The words are a bit different here than in the *1844 Manuscripts*, but the argument is the same: the capitalist mode of production, by necessarily and systematically dividing labor to the greatest extent possible, denies most working people the opportunity to do the kind of creative work that Marx thought was essential to their humanity.²

How do capitalists force workers to do jobs that are so physically and spiritually deadening? With the development of manufacturing (used in this context to mean, “production by hand”) in 17th- and 18th-century England, and with the industrialization that followed, production moved from homes to factories. Small farmers and cottage-industry producers had never had much control over the prices paid them by large merchants, but industrial workers had even less control over all parts of their work. Because factory workers toiled for owners rather than for their own immediate benefit, the owners monitored their efforts carefully. Indeed, industrial production created the need for a new kind of worker—managers and supervisors—to keep other workers doing increasingly alienating work. The division of labor, Marx put it, gradually separated “the hand from the brain” in capitalist workshops by generating ever more tasks demanding simple, repetitive motions but not much knowledge or control of the whole production process. This knowledge, originally held by workers, was transferred to managers. Marx often compared the factory system to the way military officers keep the ranks in order. As he put it in *Capital*, when production begins:

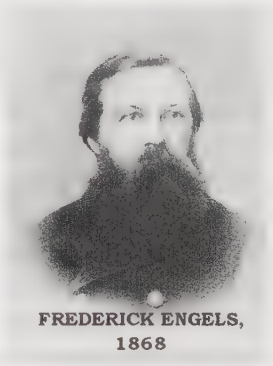
...[the capitalist] hands over the work of direct and constant supervision of the individual workmen, and groups of workmen, to a special kind of wage-laborer. An industrial army of workmen, under the command of a capitalist, requires, like a real army, officers (managers), and sergeants (foremen, overlookers), who, while the work is being done, command in the name of the capitalist. (Marx 1967, 332)

To Marx, the increasing complexity of production in capitalist systems demanded ever more complex and sophisticated ways to keep workers performing jobs they typically do only in order to pay their bills.

What people involved in capitalist firms want from the experience varies with their relationship to the firm: do they own, manage, or supervise the work, or do they do it themselves for wages? The owners want brisk, timely, committed work, done as quickly as quality standards will allow. They want workers to show up on time, to stay as long as they are supposed to, and longer if possible, and to perform flawlessly, efficiently, and without complaint. Workers, though, compelled to make a living, would prefer a friendly, flexible environment, over which they have some measure of control. Thus, workers engaged in alienating jobs keep their noses to the grindstone only when forced to do so by managers, supervisors, electronic monitors, spies, or whatever else the owners can use to compel them to greater productivity.

In brief, then, the major players on the capitalist field are capitalists hustling for profits and workers hustling for a wage or salary. We have described the two main classes in the way that Marx chose to describe them, “in relation to each other.” By this he meant that the term “capitalist” refers to someone who hires “wage laborers,” that neither can exist without the other. Their relationship to each other produces the central dramatic action of the capitalist mode of production. Like all good dramatic action, this one is a waxing and waning struggle, and, in this case, what is being fought over is what Marx called “surplus value.”

Surplus value. Marx used this term to describe the origin and source of the capitalists’ profits. This is a very different explanation of profit than that offered by mainstream economists. To appreciate the difference, consider the following (quite typical) version from a popular mainstream principles textbook:



Profit can be looked at as the reward you get for taking a chance for society, and winning. If you hire some factors of production and make something the people want, and if you do it efficiently, you will be rewarded. Your profit is your reward. But if you guess wrong you get no reward. You lose. Your loss is your “punishment” for using society’s resources in ways the society didn’t want its resources to be used. (Bowden and Bowden 1995, 63)

Let’s look at Marx’s alternative tale about how profits emerge in capitalism. Marx defined “surplus value” simply as the difference between the value of what a worker produces and what he or she is paid. Capitalists take this as profit, although it comes from the labor of the workers. In his analysis, Marx adopted what he calls “socially necessary labor time” as his standard of value for products exchanged in the market. The exchange value of a good or service is determined by the average number of hours of labor time that went into its production. In other words, Marx advanced one version of the general argument that the value of goods is determined by the labor that goes into them. The issue of what gave products their value had been debated by social theorists before Marx, and Adam Smith and David Ricardo were only the most prominent among the many who had earlier put forward this kind of “labor theory of value.”

Marx’s own version of this theory was much more closely argued, and he used the first several chapters of *Capital* to work out its internal consistencies and logical implications. In these chapters, Marx assumed that value, as he defined it, would in the long run determine (more or less) market prices. In Volume III of *Capital* Marx attempted to prove that the labor theory of value could be used as a basis for determining market prices. However, many critics have not been persuaded, and the debate continues. Fortunately for us, the framework Marx established about value is useful in analyzing capitalism, and this is true whether value determines prices, as Marx argued, or not. In the example below, we will work with the market prices of labor, materials, capital equipment, and products, rather than their embodied “socially necessary labor time.” And, as we shall see, doing so does no harm to the analysis.

The idea of surplus value is easy to understand for anyone who has worked for wages or for a salary. Take for example, a young woman, a recent graduate from college who is offered \$26,000 dollars a year to work for a capitalist company. What can we surmise about this transaction? The former student will likely be taking such a job because she is making an important transition in life and will soon pay the bills heretofore paid by her parents. She will probably have surveyed the possibilities and taken the best job available, given all

her needs. What we know for certain is that the owner will be looking for one thing from the work of the student, and that thing is profit. In a nutshell, then, our new worker will be expected to produce something over \$26,000 of new value. She will also be using equipment and materials in her work, and the owner must of course pay for these, too. But, in our example, such costs are assumed as already paid, and we are focusing solely on the new value added by our ex-student. She knows the rules too, we can be sure. She knows that if she does not produce an amount of value greater than the \$26,000 that she's paid, she will unceremoniously be ushered out the door.

None of this would be news to anyone raised in a capitalist society, though mainstream economists choose to look at it differently. Of course, they know that workers are hired to make profits for a firm, yet they typically avoid analyzing the historical processes that created that array of social classes and the resulting distribution of income and power. However, Marx was centrally concerned with the way this distribution came to be and how it shaped profit-making, once established. To answer these questions, Marx developed a detailed historical description of how the land and tools necessary for production were stripped from peasants and artisans, forcing them to work for wages in order to survive. Under capitalism, when the entrepreneur and the worker arrive at the workplace to seek their fortunes, the principal rule that emerged from this historical (rather than natural or divine) process is that the worker must labor to produce surplus value for the entrepreneur.

Marx explained the ways in which capitalists extracted surplus value from workers in his analysis of the working day. In this discussion, to which we now turn, he probed a number of interesting questions that mainstream economists long ago stopped asking.

The Working Day

At the beginning of his great historical essay called "The Working Day" (Chapter 10 of *Capital*), Marx broke down the day into two parts, creating a very simple model but one with complex implications. He asked the reader to look at the day of the typical employee as comprised of two parts, as follows:



The first of these parts, A—B is the part of the day it takes for the worker to produce enough output to pay for his or her wage. We can more clearly exemplify this if we continue to use the example we began earlier with our recent graduate making \$26,000 a year. We have chosen that apparently

random number on purpose because it allows us to draw a simple example to make the point. Such an annual salary would come to \$500 a week, or \$100 a day. This means that, on average, each day this worker must add extra value to the firm's output of more than \$100 in order to justify continued employment.

To extend the example, let's assume that this employee adds value to the firm's output of \$160 a day or, assuming the typical eight-hour day, \$20 an hour. Already, we can see that the employee is making surplus value (profit) for the owner, because the \$160 of added value is more than the \$100 daily salary. As we take one step further into this analysis, we move away from the depoliticized firm of the mainstream and into the world seen in Marxist terms. That step is simply to say this: if the employee is adding \$20 per hour of value she will have produced enough value to pay for her wage during the first five hours of the day. Given the eight-hour workday in our example, that means for the last three hours our ex-student will be producing *surplus* value for the capitalist, the only reason why she was given the job in the first place. Marx called the first five hours of this day "necessary labor" and the remaining three hours "surplus labor" to differentiate the part of the day the worker was working for the wage, and the part of the day spent toiling to produce the owner's profits.

Marx focused the whole center section of *Capital*, several hundred pages, on these last three hours, or the B—C part of the day. He did so because this is the part that provides the capitalist with surplus value, the quest for which is the distinguishing trait of capitalism. Marx did not, in his theorizing anyway, pass judgment on the process of creating and maximizing surplus value in capitalism. As we have already learned, the capitalist is only doing what is necessary to survive, and the worker is doing the same thing. The nature of the working day, in Marx's view, is a way to look at the experience of most people who live in a capitalist culture, because most of them do work to produce surplus value for someone else. What did Marx make of this particular configuration of the day? The answer is "just about everything," and here we will take up the most important ones.

Extending the working day. To begin with, we can ask ourselves a simple question: what are the ways the owner of a firm can increase the B—C part of the day? One immediate way would be simply to extend the length of the working day. Marx called surplus value generated this way "absolute surplus value," to distinguish it from "relative surplus value," which we will take up soon. If our recent graduate worked ten hours a day, rather than eight, this would generate roughly another \$40 of surplus value for the firm. The rub,

of course, is that it is illegal for the owner to do that in most modern capitalist countries without paying a premium for “overtime” hours. Marx describes the political realities of the length of the working day this way:

But when the transaction was concluded, [the worker] discovered that he was no “free agent,” that the period of time for which he is *free* to sell his labor-power is the period of time for which he is *forced* to sell it, that in fact the vampire will not let go “while there remains a single muscle, sinew or drop of blood to be exploited.” For “protection” against the serpent of their agonies, the workers have to put their heads together and, as a class, compel the passing of a law, an all-powerful social barrier by which they can be prevented from selling themselves and their families into slavery and death by voluntary contract with capital. In the place of the pompous catalogue of the ‘inalienable rights of man’ there steps the modest Magna Carta of the legally limited working day, which at last makes clear “when the time which the worker sells is ended, and when his own begins.” (Marx 1967, 416, emphasis added)

Some of the more compelling periods of U.S. and British history, and that of all capitalist societies, were the periods that saw the battle waged over the length of the working day. When Marx was writing *Capital* in the 1860s, British laborers were engaged in protracted and often bloody battles with owners over the conditions of work in virtually every industry.

The most intense, and often quite violent, elements of the struggle between capital and labor in the United States occurred roughly between 1865 and 1920. For a vivid portrayal of this struggle, see the late Howard Zinn’s powerful book, *A People’s History of the United States*, Chapters 10-15. Marx saw the battle over the length of the working day as an inevitable outcome of the capitalist mode of production, and focusing on the B—C part of the day made it obvious why this was the case. Both parties, owner and worker, have diametrically opposed needs: the former has strong incentives to keep the worker on the job as long as possible, while the latter will typically strongly prefer to make the workday shorter.

Struggles over laws concerning the workday, along with a tangled forest of others that have sprung from the same soil, exist in all advanced capitalist countries. There have been unending political battles in the United States for the past sixty years over workplace safety, Social Security, unemployment compensation, minimum wages, welfare, international trade, monetary and fiscal policy—to name only a suggestive list of issues.

Once the length of the working day is fixed, the essential nature of the “contested terrain,” as economist Richard Edwards described the workplace, does not change. Surplus value remains the goal of owners, while high wages and good (if not easy) working conditions are the goals of workers. What’s a poor owner to do? Consider again the working day, A—B—C. If “A—C” is limited by law to represent eight hours in total, and the owner wants the part of the day in which the workers produce surplus value, B—C, to be as long as possible, what are ways to expand that part of the day? The answer must be to restructure work so that the laborer pays for the wage earlier in the day; or, in terms of the diagram, to restructure work so that “B moves to the left.” Marx called profits made by such changes *relative* surplus value, and distinguished them from profits made simply by lengthening the working day.

Technological displacement of workers. Market competition and the hunger for surplus value always force owners to replace their workers with machines when it is profitable to do so. Making workers more productive with better, faster machines means that they pay for their wage earlier in the day. Marx took up the issue of machinery at great length in Chapter 15 of *Capital*. Although his argument concerns British industrial capitalism in the 19th century, his point remains relevant. He says this:

[A] machine immediately becomes a competitor of the workman himself. The self-expansion of capital by means of machinery is thenceforward directly proportional to the number of the workpeople, whose means of livelihood have been destroyed by that machinery. The whole system of capitalist production is based on the fact that the workman sells his labor-power as a commodity. Division of labor specializes this labor-power, by reducing it to skill in handling a particular tool. So soon as the handling of this tool becomes the work of a machine, then ... the workman becomes unsaleable.... That portion of the working-class thus by machinery rendered superfluous, either goes to the wall in the unequal contest of the [other outmoded industries] or else floods all the more easily accessible branches of industry, swamps the labor market, and sinks the price of labor-power ... (Marx 1967, 405-6)

Of course, this is the natural process by which technological unemployment occurs in capitalism. As an example from our own capitalist world, assume a capitalist firm that can make 1,000 units of a commodity at an average price of \$1.00, with a process that uses one machine and 100 workers.

Then, a supplier drops by with news about a new machine which will allow the owner to produce the same 1,000 units but with only 50 workers and at a cost of \$.80 per unit. Will the capitalist fire 50 of his workers? Almost certainly, though he or she might first of all use the threat of the machine as a way to speed up the work and increase productivity that way.

In the two preceding chapters, 13 and 14, Marx had demonstrated, as he had in *The Communist Manifesto*, a genuine appreciation for the ability of the bourgeoisie to develop technology rapidly enough to transform the world with a previously unprecedented breadth and speed. He remained committed to the idea that machines could, in a mode of production designed for “free men,” deliver people from the drudgery that has been the lot of most of them throughout human history. Yet, with the emergence of a system whose central dynamic is the production of surplus value, the machine becomes the agent of the worker’s displacement, it promotes the exploitation of women and children, and, most horribly, it crushes workers between its moving wheels. Selected quotations from Chapter 15 will make his point. On the moral imperatives of capitalism and the machines, Marx wrote:

In so far as machinery dispenses with muscular power, it becomes a means of employing laborers of slight muscular strength. ...The labor of women and children was, therefore, the first thing sought for by the capitalist who used machinery. (Marx 1967, 372)

and:

[M]achinery sweeps away every moral and natural restriction on the length of the working day. Hence, too, the economic paradox, that the most powerful instrument for shortening labor-time, becomes the most unfailing means for placing every moment of the laborer’s time and that of his family, at the disposal of the capitalist for the purpose of expanding the value of his capital. (Marx 1967, 385)

Concerning dangers of the factory, Marx had this to say:

[In the factory] every organ of sense is injured in an equal degree by artificial elevation of the temperature, by the dust laden atmosphere, by the deafening noise, not to mention danger to life and limb among the thickly crowded machinery, which, with the regularity of the seasons, issues its list of the killed and wounded in the industrial battle. (Marx 1967, 401)

On this last point, Marx was writing about mid-19th century working conditions in Britain, rather than capitalism today. But we should not presume his comments about safety are outdated. The April 2013 issue of the *British Columbia Federationist*, using data from the International Labor Organization, tells a bit of a horror story in describing the maiming and fatalities that workers on average must incur in order to get their wages. That story starts with the news that every day, 6,300 workers around the world die, and then goes on:

Every year, workers suffer from 317 million work-related injuries.

Every day, workers suffer from 870,000 work-related injuries.

Every year, workers suffer from 160 million non-fatal occupational diseases.

Every day, workers suffer from 440,000 non-fatal occupational diseases.

Cutting wages. Let's assume that the student from our earlier example is toiling away for \$26,000 a year in a capitalist firm with one hundred workers, and then the owner decides to cut wages for all of them. Doing so would increase surplus value by moving the "B" part of the work day to the left, if we assume productivity doesn't change, because at a lower wage workers will provide enough extra value to pay for their wage earlier in the day. Will the workers accept these wage cuts like good soldiers? It depends, of course, and Marx made it clear he believed this battle over wages, like that over all the other conditions of work, would wax and wane.

As an excellent example of this ongoing struggle between capital and labor over wages, for about 25 years after World War II, real wages for American workers (that is, wages after accounting for inflation) rose regularly. This was because of steadily rising productivity and because, with roughly one-third of the workforce unionized, including virtually all wage-earners in the big industries, labor unions had genuine collective power at the workplace and on the national political scene. However, for several reasons, including declining employment in the manufacturing sector, globalization, and the intentional strategies of major capitalists to reduce the rate of unionization, labor's power relative to bosses began to decline in the early 1970s. Since then, the rate of unionization has fallen dramatically, from 27.9% in 1970 to 11.1% in 2015. Now real wages for an hour's work are lower for most workers than they were in 1972. The current generation of "bottom line" employers is no more cold-blooded than their counterparts from, say, 20 years, or 120 years ago. The difference is that the weakened political power of workers allows the cold-bloodedness, ever lurking in capitalism, to prevail where it could not in the 1950s when unions were powerful.

To put it another way, if we ask when employers try to lower the wages of their employees, the answer comes quickly to any of us: whenever they can get away with it.

Speeding up the workplace. Consider again our student and her 99 fellow workers in the hypothetical capitalist firm. Let's say that this company provides consulting services to other firms.³ Maybe fifty of its employees work with computers to keep information flowing through the office, or to keep tabs on costs; maybe the other fifty are outside the office consulting, drumming up customers, or hanging out when they can get away with it. How could the owner speed up the work of these hundred employees? Or, formulaically, how can he or she make them more productive and, by doing so, enlarge the B—C part of the workday? The owner could monitor the work of those fifty on the computers, rank them according to their speed, and publicize the rankings. Or, the owner might devise ways to speed up the efforts of the outside workers by increasing the number of contacts they must make, or by transferring to them some of the computer work usually done in the office. When, we ask again, will the owners/managers speed up the work of employees? The answer, again, is: whenever they can get away with it. Further, given the nature of work in most capitalist firms, we can also predict when workers will not do the work their bosses want them to: whenever they can get away with it.

Moving the production somewhere else. Another method by which owners try to enlarge the B—C part of the day is to seek out lower wages somewhere else. Most of the shoes worn by Americans used to be made in mills in New England, produced by family-owned firms that dominated local economies but nonetheless provided relatively high wages and a good measure of job security. Gradually, the plants were moved to the southern United States because wages were lower there and, stemming from the same conditions that generate low wages, there was a relative hostility to organized labor. But before long, producers were moving their mills further south to places like the Dominican Republic, where wages were even lower; then, the move was to Taiwan and South Korea. This quest for the lowest wages reached its nadir when the Nike Corporation moved its production to Indonesia, where in the early 1990s, its subcontractors hired young women to make Nike shoes for fourteen cents an hour.

To sum up Marx's arguments about "relative surplus value": he showed that confining the length of the working day to a maximum number of hours did not change the essential dynamic of the capitalist mode of pro-

duction. It simply mandated that capitalists “intensify labor,” to use Marx’s term, in order to maximize surplus value. Concretely, this meant cutting wages, speeding up work, replacing workers with machines, and marching around the globe in search of low-wage workers.

The Industrial Reserve Army

In Chapter 25 of *Capital*, Marx theorized about the horrific conditions endured by so much of the working class in Britain. His guides into this territory included dozens of reports of Parliamentary investigations, as well as Friedrich Engels, whose book *The Condition of the Working Class in England* (1844) had early on helped draw Marx’s attention away from philosophy and toward political economy. In Chapter 25, Marx paid particular attention to the nature of what we call “unemployment” and the reasons that it regularly occurs in capitalism. What distinguishes Marx’s treatment from current ones is in part the tone of his writing. Marx called those without jobs in capitalism “the industrial reserve army.” His words conjure complex images that present a far richer notion about workers without jobs than the abstract mainstream term “unemployment.” Consider the implications of Marx’s term. First, he uses a military metaphor, “army,” reminding us that those without jobs are foot soldiers in some capitalist’s army and, like their counterparts in the real army, utterly at the mercy of the “generals” directing the struggle. More important, however, is the word “reserve,” which in Marx’s definition carries crucial political and economic implications.

The unemployed in Marx’s system are “in reserve” in the sense that capitalists always need a pool of them in order to make surplus value. Consider an economic recession, where production and employment spiral down together, and the decline in each bringing about further declines in the other. The first workers to get the axe will typically be the last ones hired back, and they will be those considered the least skilled, least educated, least desirable for whatever reasons. If the contraction is great enough and long enough, an increasing number of those losing jobs will be more educated and experienced.

We all know this, but Marx adds the emphasis that for capitalism to function, these people must take their lumps, if not in silence, at least without posing a political threat. In other words, capitalism *absolutely depends upon* a class of people at the bottom who can be fired without explanation and who also are not able to organize resistance to the system that has tossed them out. Instead of resisting, capitalism demands that these workers graciously blame their lot on themselves, rather than blame a production sys-

THE GLOBAL SURPLUS WORK FORCE

As we described above, in the early 1980s corporations and governments under their influence ushered in the era of "neoliberalism." Politicians in most nations produced new trade rules making it easier for multinational corporations to look abroad for investment outlets, low wages, and markets for their goods. It was another era justified by the claim that "free markets" allow "free enterprise" to spread "freedom" everywhere. The rush then and now for cheap wages is readily understandable. In 2008, hourly wage rates, in U.S. dollars, were 31 cents in Bangladesh, 63 cents in India, \$1.60 in China, and \$35, or more, in the richest countries. Low-wage workers, around the world, are typically peasants driven from the land by the growing industrialization of agriculture, and into factories with starvation wages and few protections for workers. To be sure, the living standards of millions of workers in some "less developed countries" (LDCs) increased dramatically with the globalization of capital, but there were major costs, as we shall see.

A principal consequence of the unleashing of multinational corporations was an enormous growth in the global "Surplus Work Force" (SWF). Some contemporary Marxists, following Marx, see it as comprised of displaced rural workers, industrial workers replaced by machinery (such as robots), those workers in developed countries no longer able to compete with starvation wages abroad, and the vast pools of unemployed and underemployed labor in developing countries. They estimate the current SWF at between 1.5 and two *billion* people, most of them in China or India. Though the great majority still works the soil in some capacity, the expectation is that eventually they will be driven to the cities by industrial agriculture and the spread of other industries to rural areas. This group still on the farms is what Marx, and contemporary Marxists, call the "stagnant" element of the SWF.

While neoliberalism was helping to generate an immense increase in the world supply of labor, the world economy did not produce enough jobs to absorb all the workers. Thus, wages were suppressed everywhere, leading to a huge impact on the welfare of U.S. workers. In 2011, their real weekly wages were \$294, down from \$342 in 1972; there has been a significant decline in real wages over a forty year period! The SWF, and the ongoing decline in the proportion of American workers in labor unions, also created a great increase in the share of the annual income grabbed by corporate owners and other rich people. From 1979 to 2007, the average income for a middle-class family increased by 40%, but that of the richest 1% of families increased by 275%.

Scholars predict continued growth in the SWF as more countries are fully incorporated into the global capitalist system and as advances in robotics lead to large-scale substitution of machines for labor, suggesting for the U.S. economy more years of stagnant wages, more income inequality, and a government at every level that is increasingly bought and paid for by huge corporations. A look at the Communist Manifesto makes clear that, even as early as 1848, Marx was already predicting that globalized capitalism would produce these results.

tem that makes their unemployment necessary and predictable. Further, capitalist systems need the reserve army to hold down wages: a pool of unemployed, financially desperate workers reminds those who still have a job that they can easily be replaced if they make demands on their employers. And finally, the reserve army serves the needs of capitalism in times of economic growth. When the economy starts expanding, it won't grow for long unless there are people "in reserve" who can be absorbed back into the system. Naturally, the capitalists' hope is that those in reserve will not have made themselves into a *real* army in the meantime.

Throughout *Capital*, Marx fulminates and rages about the lot of workers in capitalism in between the lines of his dense theoretical arguments. It deeply provoked his moral outrage. Yet in mainstream economics, unemployment is considered either a short-term failure of the system or a long-term failure of hopeless individuals. The relationship between joblessness and the political system is also generally ignored because, as is usual in mainstream economics, politics and questions of power are cavalierly ignored.

In our own time, there is an increasing focus on this unemployed army because it now includes over a billion people in what contemporary Marxists call the global "surplus work force." As such it has become a crucial element in our understanding of the growing pressures on wage earners the world over (see box, p. 81).

Social Classes

The idea of the reserve army of the unemployed points to the fact of social classes in capitalism, about which Marx had much to say. One of the more intriguing aspects of life in U.S. society is that those who shape opinions, including many professors, essentially deny the existence of social classes. Instead of concepts such as "working class" or "ruling classes," they have substituted entirely different ideas and metaphors, such as "social status" or the "melting pot." The "American Dream" anchors a mythical understanding of ourselves, and according to this fairy tale any child can make it to the top by trying hard enough. Those who actually have done so are paraded through our media and our history books as proof of typical experiences, though they are not that at all. Research debunks the myth with a crashing finality by showing that the best way to get to the top is to be born to parents already there.

Marx wrote often about social class, both theoretically and through his accounts of key events of his times. However, his theory is quite undeveloped, and he never abandoned what he argued early on in the *Manifesto*—that society is ultimately divided into the two great camps of the bourgeoisie and the proletar-

iat. In his system, other classes were fated to extinction. One such class was the “petite bourgeoisie,” his term for small farmers, shopkeepers, craftspeople, and other owners of small individual or family business that do not hire wage laborers. He also referred to those truly outside the production system as the “lumpenproletariat,” a term very close to the current idea of the “underclass.” Marx believed that smaller firms would ultimately fail to compete with big firms and members of the petit bourgeoisie would be “hurled into the proletariat” along with all those intellectuals who did not end up as apologists for capitalism.

Some later thinkers have criticized Marx’s division of society into two classes as overly simplistic. A crucial question arises: Who is truly a worker, and who is not? Are supervisors workers? Are medical doctors? How about teachers in public schools, or in private schools? These are important questions, not always answered clearly by Marx’s choice to put everyone into two warring groups. Yet, a two-part class system is not as superficial as it might seem. Consider U.S. society, where most of us work for wages or salaries in positions where the following conditions prevail: We do not control what we produce, how it is produced, or how it is priced; we have nothing to say about whether our workplace will be open tomorrow; we must take the wage offered us, even if it is not enough to live on (unless we can easily get another job or are part of a union that will collectively fight for higher pay). And, our labor is “divided” as a matter of course, and it will be sub-divided into ever-smaller tasks as long as it is profitable for owners to do so. If these are the conditions of your job, you are a worker in the Marxian version of the capitalist world. On the other hand, if you do have some control over these matters, you are a capitalist or a high-ranking official in a capitalist firm; that is, you are in the capitalist class.

Without question, this classification is oversimplified. Owners of small firms typically have much less control over the market in which they operate than do the owners of large, powerful ones. And, there is an obvious difference in the significant control over work held by the carpenter constructing a new room to a house and the gofer bringing the exact amount of water, nails, and wood the carpenter demands. Marx was aware of these differences, and it is a complexity of the modern world that has led latter-day Marxists to construct variations on his themes, mostly by adding classes that don’t fit very neatly into any of his categories. For instance, Pat Walker’s *Between Capital and Labor* (1978) describes a “professional managerial class” made up of professionals such as doctors, lawyers, academics, and others who have some control over their working environment but who do not typically hire

wage-laborers and earn surplus value. Other scholars have, in this same vein, tried to account for these “in between” classes. In their accounting for professionals, these theorists are not abandoning the Marxist framework but are trying to modernize it so that it remains a viable paradigm in which to think about modern capitalism.

Implicit in Marx’s discussion about social class is the quite limited number of roles that can be played out in modes of production. As an example, presume that a youngster reads captivating books that make him or her want to be a shining knight, or a provincial duchess, or a hardy English yeoman, or a Plains Indian warrior, or a pioneering woman ready to prove herself when pushed up against the rough elements of the weather (not to mention patriarchy), or the fair-minded leader of a workers’ council in a democratic socialist country. It is not possible to play these, or any number of other roles, if one resides in modern capitalism, because you can only be an owner, a worker, a government servant, or someone else inhabiting a role shaped by capitalism. And inside your role, you must play it to the hilt to survive: as an owner you must worship the bottom line, and as a worker you must obey the owner. This does not mean, of course, you have no agency—no free will—but as Marx put it so very well:

Men [sic] make their own history, but they do not make it just as they please: they do not make it under circumstances chosen by themselves, but under circumstances directly encountered, given and transmitted from the past. The tradition of all the dead generations weighs like a nightmare on the brain of the living. (Marx and Engels 1978, 595)

By placing people in social classes according to “their relationship to the means of production,” Marx introduced new language and a larger, more powerful theoretical framework. Discussions of social class continue to ignore Marx at a cost. As one economist, Teresa Amott, put it:

... No matter how far from *Capital* the debate [about social class in capitalism] has strayed, Marx’s original conceptions continue to define the shape and logic of the argument. In fact, one could argue that the burden of twentieth-century thought on class has been the task of rehabilitation, elaboration, deconstruction, and contestation of Marx’s original construction of class, that to criticize Marxist concepts of class, one must stand in the space that Marx cleared. (Amott 1996)

As Amott argues, though Marx did not himself give the same kind of full theoretical treatment to social class as did many other writers, he established the framework for a discussion about social classes in capitalism that continues today. How could there not be social classes in our society when even children know that the people who own or control the businesses also own houses, cars, food, and clothes that are almost always better than those of the people who work for them?

Other Economic Arguments about Capitalism

Capital is a book of about seven hundred pages, and in it Marx covered significant territory in his analysis of capitalism. We have taken up those arguments that dominate the book and which remain most germane, even eye-opening, to readers in our own day. We have ignored some of his arguments because they do not have a great deal to say about our own world. Still other claims Marx made do not merit much explanation in this kind of review, because they are now so commonly accepted. However, we will mention two of these latter arguments because they have a particular importance to *Capital*. We will also say a few words about Marx's theory of revolution.

Booms and busts. In mainstream economics, John Maynard Keynes, as readers will see later, is generally considered to have founded the modern study of the business cycle in the mid-1930s. However, the history of economic thought is now rarely taught in graduate schools, and thus economists usually do not know that others, including Marx, had developed complex and persuasive theories of the business cycle. One problem is that Marx scattered arguments about the instability of capitalism throughout all four volumes of *Capital*, and few readers have taken the time to compile and assess his claims. Marx's arguments are also largely unknown to mainstream economists for ideological reasons, and, as we have pointed out, these economists have gradually come to ignore all that he wrote. Even though mainstream economists are rarely familiar with them, Marx made a series of strikingly modern arguments about the business cycle. One argument from Volume II is this:

The ultimate reason for all real crises [recessions/depressions] always remains the poverty and restricted consumption of the masses as opposed to the drive of capitalist production to [produce as much as possible]. (Marx 1981, 484)

This idea, called "underconsumption," which we introduced earlier, is central to most modern macroeconomic theories. In the second and

third volumes of *Capital*, Marx developed other intriguing theories of the business cycle. In one of them, Marx anticipated the ideas of Keynes in arguing that there is interdependency between the investment and consumption sectors of a capitalist economy. In Volume II, he showed with his usual logical consistency that overproduction in one of these economic sectors can produce a “realization” crisis, or what we call a recession or depression. It is only because British economists, who with Keynes developed modern macroeconomics, were not reading Marx that they did not see that much of their own work only extended what he had already written about.

The centralization of capital. Marx was the first major social theorist to predict that capitalism would lead to a growing centralization of power in the hands of a few capitalists. By “centralization,” Marx meant what we call horizontal, vertical, and conglomerate mergers (firms merging, respectively, with one of their competitors, suppliers, or firms from a completely different industry). In Chapter 25 of *Capital*, Marx explained how the capitalists’ need to mechanize production would produce ever more costly machinery and buildings. These expensive new technologies would drive down costs, and smaller firms not able to buy the newest machinery would be driven out of business or gobbled up by the bigger ones. The financial industry, too, would verge toward centralization. Ultimately, these large financial and industrial firms would shape business regulations in capitalist states to allow for more centralization in the future. Marx’s arguments on these matters are more interesting for their prescience than as new information. Yet interestingly, Marx tied the centralization of capital to the eventual collapse of capitalism, because he thought that as monopolies grew in power, they would hurl more and more workers, and the owners of small firms, into an increasingly immiserated proletariat. The result, he predicted, would be unrest and then revolution. Does that language remind any readers of recent newspaper headlines or chatter by the pundits on television?

The centralization and immiseration that Marx described have clearly been underway in most capitalist societies. For just one such effect, consider that of the immense Walmart chain. Its monopolization of retail sales has made it ever more difficult for Main Street merchants to compete with it. Walmart has two principal advantages over its smaller competitors: Its huge stores spread the overhead for each sale over hundreds of thousands of products in the typical store. And Walmart directly purchases sizeable propor-

tions of the total output of such giants as Procter & Gamble. This gives it the market leverage to buy at volume prices considerably lower than those charged to smaller outlets. Direct purchases such as these immediately wipe out whole strata of small wholesalers and threaten all retailers that compete with the giants. Millions of small business owners, particularly those who are not highly educated or do not have professional skills, have been hurled into jobs with low pay and no control over their work.

With Walmart, capitalism has come up with the perfect “surplus value” machine, and it has been the great pioneer in the box-store revolution. Likely the most prominent follower has been Amazon.com: It now marches across the globe sweeping away book stores and replacing employees who like to talk about books mostly with ones who only are allowed to move them from one place to another one.

The theory of revolution. In a typically rousing rhetorical outburst in the next-to-last chapter of *Capital*, Marx predicted that capitalism was doomed and that it was but a matter of time before the capitalist “expropriators”—another of his terms for capitalists who extract surplus value—were themselves “expropriated.” (715) Marx argued that booms and busts would grow increasingly tumultuous, each one leaving more small firms driven from the field and more workers in ever-greater misery. That tumult would eventually lead to an overthrow of the capitalist class. That this has not happened is a testament to the resilience of capitalism and its great capacity to adapt to technological and political changes. Marx was aware of this adaptability, and in particular, he thought that in democratic capitalist societies workers might restructure the system and make it more “civilized” without overthrowing it. In his view, however, a “reformed” capitalism, with laws providing improved working conditions and less income inequality would still be exploitative and workers would remain alienated. In this sense, efforts to reform capitalism would simply prolong the oppression of the working class. To some degree, this is what happened in the capitalist welfare states in Northern Europe, as we shall see in the chapter on Sweden.

Whether the workers of the world will ultimately “unite” and overthrow their oppressors remains to be seen. Capitalism continues to experience recurring crises that throw hundreds of millions of people out of work and to leave billions of people without enough to live on. Further, financial crises, such as the one that began in 2007, usher forth recessions or depressions and other destabilizing events and slow economic activity the world over. At what level of world unemployment would Marx’s prediction about revolutionary up-

heaval come true? It remains to be seen. In fact, capitalist societies might reach a tipping point due to a growing level of unemployment around the world, especially if that problem were added to food shortages or other problems caused by global climate change. Probably the best way to consider with some clarity whether capitalism will last forever, or even for much longer, is to familiarize yourself with current world events and then decide for yourself.

The Moral Standing of Capitalism

In the last six chapters of *Capital*, Marx took up a fundamental question: where does accumulated capital originate? He answered that it had begun with slavery and imperialism. The substance of his answer is embodied in his idea of what he called “primitive accumulation.” In Chapter 31, he provides key historical examples:

The discovery of gold and silver in America, the extirpation, enslavement and entombment in mines of the aboriginal population, the beginning of the conquest and looting of the East Indies, the turn of Africa into a warren for the commercial hunting of [black people], signaled the rosy dawn of the era of capitalist production. (Marx 1967, 703)

These examples follow two chapters on the enclosure movements, particularly in Britain starting in the 16th century and continuing up to Marx’s time. The first great producer of a “Surplus Work Force” in the capitalist world was *enclosure*, a process by which the crown, the land barons, the church, and eventually the capitalists, seized for their own use vast stretches of land long used by peasants and the yeomanry to produce their livelihood. The effect was to drive most of this agricultural work force into the cities as vagabonds or wage laborers.⁴ For British peasants whose livelihood was stolen, enclosure was brutality, and its example was a key one that led Marx to argue that capital originated in plunder and violence. Because wealth and power are passed down from generation to generation, this early pillaging remained the foundation of the distribution of wealth and power in Marx’s time. Later on in the chapter, Marx hurled forward this verbal thunder:

If money, according to Augier [a Frenchman writing in 1842] “comes into the world with a congenital blood-stain on one cheek,” capital comes dripping from head to foot, from every pore, with blood and dirt. (Marx 1967, 760)

In these last six chapters, Marx made two interconnected claims. The first was that capitalism was born in pillage and murder, and the second was that it is a system of unremitting oppression and violence against working people. Do these claims have any merit as descriptions of modern capitalism? Was U.S. capitalism built on violence and plunder? Does it remain oppressive to the majority of the people who live in it?

The answer, of course, depends on whom you ask. The history of the United States has received countless tellings, offering dramatically different answers to these questions. Were John D. Rockefeller and J.P. Morgan “robber-baron” criminals, as some historians have concluded? Or was their inexorable drive to accumulate profits and their need constantly to revolutionize the means of production the forces that brought modern industrial capitalism into being? Or were capitalists both plunderers and revolutionaries, as seems to be Marx’s position? For those who adopt the benign meritocratic view of capitalism, its inequalities of opportunity and outcome can be justified with the claim that it has always been an open system in which all who genuinely make the effort can rise to the top. This view is, without question, the dominant one in our times.

Others, though, see things quite differently. They argue that central to modern capitalism are owners and managers who by definition live off surplus value produced by someone else; who must create mindless tasks for most of their workers; who must withhold loyalty to their workers; who must fire, or replace, or even harm their workers’ health, if doing so will increase their surplus value; and who must monitor their workers’ efforts to keep them on jobs which many hate.

This is a language of force and oppression, and to a Marxist it is also the language of plunder and pillage. Surplus value, expropriated from the workers only because the capitalists control the productive system, is the means by which these owners build their fortunes, amass their political power, and dominate the capitalist world. And capitalists’ quest for surplus value requires them to do damage to everything in their path. Consider tobacco executives who kill their customers for surplus value; or Nike’s Phil Knight and Apple’s Steven Jobs, who become billionaires by having thousands of foreign workers toil for poverty wages and under wretched conditions; or the countless chemical companies that have filled the air and water with poisons and have fueled global warming without pausing for a moment to consider the long-term consequences. Are such characters on the modern capitalist stage any different from the “blood-sucking werewolves” of Marx’s world? Like everything else, it depends on your point of view.

III. CONCLUSION

Marx was a prodigious writer, and this introduction is meant to urge readers to look into his work for themselves. Whereas we have tried to explain Marx's conception of history, and the basic ideas about capitalism advanced in the first volume of *Capital*, the other works of Marx and Engels contain thoughtful elaborations of their ideas, often in powerful and elegant language.

If one wants to take on *Capital*, or some of Marx's other more demanding texts, the best way to do so is in a college course or a reading group. On the other hand, much of what Marx and Engels wrote is quite accessible, and interested readers can certainly browse and read independently. Our readers should give Marx another chance and not listen to those who claim from the rooftops, "Marx is dead!" Quite frankly, that is a claim that could only be made by someone who has never read his works.

SUGGESTIONS FOR FURTHER STUDY

On YouTube. As an aid better to understanding Marx's arguments, we recommend presentations by two Marxist scholars, David Harvey and Richard Wolff. (Just search by author name.) For those interested especially in Marx's *Capital*, Vol. 1, we recommend Harvey's chapter-by-chapter analysis.

Reading. There is an enormous volume of written material on Marx and Engels, and we would suggest that in searching for a particular item you might want first to check the Marx/Engels Internet Archive. In the case of the works cited below, some of which are in the Archive, there are many publishers of most of them. We have thus confined reference information to the initial publishing date of each one.

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4

Thorstein Veblen and the Predatory Nature of Contemporary Capitalism



INTRODUCTION

Thorstein Veblen is another of the political economists whose theories of the economy diverge significantly from the standard neoclassical (i.e., mainstream) analysis that is offered in standard economics textbooks. Veblen's system of analysis has some similarities to that of Marx. Veblen treats the modern American economy as being dominated by business interests and inherently prone to cyclical crises, rather than resembling the mythical, perfectly competitive world

created by Adam Smith. Veblen also makes conscious use of learning from the other social sciences in order to analyze the factors that he thought to be most important for understanding the economy—economic and social change.

Before we proceed, let's dismiss one of the common complaints about Veblen: his unique writing style. Critics of Veblen, and even many of his admirers, characterize much of his writing as irony, and some dismiss his work as humorous satire. As one example, a famous passage from Veblen examines the role of habit in human thought processes. In this passage, Veblen observes that the "patriotic spirit" is less the product of individualistic rational choice by citizens of a given country than the result of inculcation of certain feelings of sentiment and loyalty by our peers and national institutions. In other words, according to Veblen, most of us arguably gain a feeling of national pride from living our lives in a particular country or region, but that pride is derived not from a careful comparison of the relative costs and benefits of living in our own country and a rational assessment of the relevant

institutions and government apparatus, but instead from our tendency to be loyal to and fond of our own home country just because we know it best:

The patriotic spirit, or tie of nationalism, is evidently of the nature of habit. ... More particularly is it a matter of habit...what particular national establishment a given human subject will become attached to on reaching what is called "years of discretion" and so becoming a patriotic citizen. The analogy of the clam may not be convincing, but it may at least serve to suggest what may be the share played by habituation in the matter of national attachment. The young clam, after having passed the free-swimming phase of his life, as well as the period of attachment to the person of a carp or similar fish, drops to the bottom and attaches himself loosely in the place and station in life to which he has been led; and he loyally sticks to his particular patch of ooze [sic] and sand through good fortune and evil. It is, under Providence, something of a fortuitous matter where the given clam shall find a resting place for the sole of his feet, but it is also, after all, "his own, his native land" etc. It lies in the nature of a clam to attach himself after this fashion, loosely, to the bottom where he finds a living, and he would not be a "good clam and true" if he failed to do so; but the particular spot for which he forms this attachment is not of the essence of the case. At least, so they say. "It may be, as good men appear to believe or know, that all men of sound, or at least those of average, mind will necessarily be of a patriotic temper." (Veblen 1998, 134-135)

Veblen's writing was often characterized by such subtle sarcasm, but the sarcasm masked cogent and important analysis. To quote his most famous student, Wesley Clair Mitchell, "there [was] always an aura of playfulness about his attitude toward his own work in marked contrast to the deadly seriousness of most economists." (Quoted in Galbraith 1972, v) The humor sometimes employed by Veblen may have softened his message somewhat. As John Kenneth Galbraith put it in his introduction to a 1972 reissue of *The Theory of the Leisure Class*, "That Marx was an enemy whose venom was to be returned in kind, capitalists did not doubt. But not Veblen. The American rich never quite understood what he was about—or what he was doing to them."

As we will see, Veblen coined a number of phrases well-known to us today: phrases such as "conspicuous consumption," and "leisure class," and "captains of industry." These were not mere clever turns of phrase, but rather theoretical concepts as central to his system of analysis as concepts such as self-interest and profit-maximization are to neoclassical analysis. To understand the importance of conspicuous consumption or to see the role played by the captains of industry, we will situate those terms within his system of analysis.

THE ROOTS OF VEBLEN'S UNDERSTANDING OF THE ECONOMY

Veblen was a careful observer of the changes taking place in the United States economy at the beginning of the twentieth century and an innovating economist who specialized in studying economic change. Many of Veblen's views of the economy were conditioned by his father's experience as a farmer in Minnesota contending with the changing economy of the post-Civil War United States. In the early 1870s, Midwestern farmers had taken advantage of new agricultural technologies to improve wheat processing and, in turn, to expand their production. As you learn when you study the operations of competitive markets, a bumper crop causes a rightward shift in the supply curve that tends to lower prices—a good thing for consumers, but not necessarily for farmers. Indeed, lower prices led to falling incomes and economic misfortune for many farmers. Farmers attributed their financial woes to the groups who seemed to be prospering. To quote Joseph Dorfman, biographer of Veblen, farmers reacted with a “wave of bitterness against the business interests...from the country-store trader and banker to the railroad company.” (Dorfman 1961, 14) Fellow Minnesotan and chief lecturer for the Grange, Ignatius Donnelly, lamented in 1873: “Could the ordinary man retain his economic independence, or must he become the wage slave of the possessor of great wealth?” (quoted in Dorfman 1961, 16)

Midwestern farmers believed themselves to be victimized by several categories of villains: the railroad tycoons who raised their rates and made it costlier for them to ship their produce to the East, the bankers who advanced loans to them and then demanded payment even when falling prices destroyed the farmers' profits, the jobbers or wholesalers who bought the farmers' produce at low prices and resold these products at higher prices. To the typical farmer, it appeared that he was doing all the productive work and losing money while the railroads, middlemen, and financiers were profiting at his expense. Yet the decisions of the railroads, middlemen, and financiers, at a remove from the farmers and workers, dictated the economic fortunes of the actual production workers. Below we will explore this distinction between what Veblen called “pecuniary” and “industrial” activities in more depth.

Veblen also examined other conflicts which he thought were central to the pace and direction of economic change. For Veblen, the conflict between scientific or “matter-of-fact” thinking and superstitious or animistic thinking explained the often slow pace of change in our increasingly technological society. According to Veblen, past-binding thinking locked society into habitual ways of thinking and being. Even today we can find examples, ranging from persistent superstitions about Friday the thirteenth, to the persistent

gender and racial stereotypes that hinder women and minorities from rising to the top of corporate hierarchies or earning salaries comparable to their white male counterparts. In the same way, we can see the conflict between what Veblen once referred to as “imbecile institutions” (his term for past-binding behavior) and the logic of the machine process, his metaphor for modern production techniques. This conflict, in Veblen’s view, could impede technology’s path and even alter its beneficent consequences. In one obvious example, the modern school year in the United States still includes a three-month summer break, even though that summer break no longer serves its original purpose, which was to free children to work on family farms during the busy summer growing season. As a result, U.S. children attend school on average two fewer months during the year than Japanese children.

VEBLÉN’S EVOLUTIONARY ANALYSIS

Veblen, like many early economists, was first trained in philosophy, so he took great pains to examine the philosophical foundations of the received economics of his day. He found that those foundations were outmoded for understanding the kind of economics emerging in the twentieth century. Mainstream economics then and now relied on the philosophical underpinnings of natural law that swept social science thinking in the late eighteenth century. This was the period during which Adam Smith wrote the *Wealth of Nations*. Smith and other early classical economists were influenced by the work of Isaac Newton, and they described the social world in the same terms that physical scientists used to describe the physical world. The physical universe was seen as an immense clock set into motion by a Divine Clockmaker, and the social universe was seen to be similarly well organized and mechanically ordered. Just as the Newtonian laws of physics kept the physical world operating in orderly fashion, the “natural” economic laws of the marketplace would channel the self-interested actions of human beings toward mutually beneficial outcomes for all. The natural order of the social universe was believed to be a system of free markets, with humans free to consume and to work as they pleased, but controlled, if not by the Divine Clockmaker, then by his close counterpart, the “invisible hand.” Adam Smith developed this metaphor to describe the impersonal market forces which he and his followers believed regulated the economy, a natural regulator that precluded intervention by earthly (government) regulators.

The Newtonian worldview led economists to see a world that was for the most part fixed and immutable. To quote David Hamilton, these early economists assumed that “the social order of their day was the natural product of

sufficient reason and therefore fixed.” (Hamilton 1991, 22) Most economic historians agree that Adam Smith’s England in 1776 did in fact resemble the microeconomic model of perfect competition, even though large joint-stock companies dominated much of England’s international trade. (Heilbroner 1999)¹ Hence Smith could justifiably construct a model of a perfectly competitive economy, where many small producers competed and self-interest alone sufficed to maintain social order and to produce the maximum economic welfare for all members of society. Influenced by the natural law tradition in philosophy, Smith also assumed that the economic world had reached its ideal form with the flourishing of competition in late eighteenth century England. Analysis of change was deemed irrelevant, because the “classical” economists believed they were describing the archetypal economic system that would henceforth prevail always and everywhere. In such a world, analysis of economic change could be restricted to analysis of the temporary movements away from competitive market equilibrium. The main question to be answered, then, was: When demand rises for one product or falls for another product, how will the market reach a new equilibrium price and quantity?

Veblen argued that an evolutionary model was more useful for understanding the economy that was emerging at the end of the nineteenth century. Writing one hundred years after Smith, and observing the economic changes that had so concerned Marx, Veblen, like Marx, declared that the social universe was not fixed and immutable. Indeed, Smith had described a transitory epoch, according to Veblen. Writing in an age in which a Darwinian model of evolution was being adopted in the biological sciences and imitated in some of the social sciences, Veblen adopted an evolutionary model to explain the cumulative causation and constant change that he observed.² Indeed, during the period that Veblen wrote most of his major works, 1898 to 1923, evidence abounded that economic and social change was a permanent feature of the economy. New technologies allowed for mass production of goods and services, transforming industries that may have once conformed to Smith’s model of atomistic competition, into industries now dominated by a few large multinational firms. Moreover, a huge wave of mergers and acquisitions at the turn of the 20th century created huge national and multinational business firms that dominated their industries and transformed the nature of competition. The economists who clung to Smith’s theories and applied them to the greatly changed economy of the late nineteenth century assumed that the natural order of the world (in the form of placid price competition) would quickly restore Adam Smith’s ideal economy.

Veblen's use of the Darwinian approach did not mean that Veblen believed in survival of the fittest, despite the fact that Veblen actually studied under William Graham Sumner, one of the architects of social Darwinism. Veblen took from Darwin and Sumner a different scientific method, "which studies humanity in its process of continuous adaptation to both its social and natural environment and which sees the conditions of human existence as subject to ceaseless change." (Tilman 1993, xxvi) It is not survival of the fittest that is relevant to understanding economic and social change, but rather the simple fact of evolution as adaptation of past practices to modern circumstances, which may or may not represent progressive change. As a simple example, the modern practice of men wearing ties—a non-utilitarian adornment that fits tightly around the neck of most men who move in professional circles—for important social or professional occasions, dates to an era where men used their ties or cravats to wipe their faces while eating. Over time, ties evolved into the quintessential symbol of the gentleman of business, even though the modern businessman would no sooner wipe his face on an expensive silk tie than he would appear in public with a cheerful checked napkin wrapped around his neck. Less obviously, perhaps, but more importantly, Veblen observed that the nature of the work performed by entrepreneurs, or to use his word, "undertakers," also evolved considerably as large multinational firms came to dominate the U.S. economy. Businesspeople in the mid-nineteenth century conducted the financial and managerial affairs of their businesses, but also spent time on the shop floor working alongside their own workers. Thus they had constant exposure to the working conditions of the average production worker. By the end of the nineteenth century, the undertakers had become "captains" of industry and finance who managed their operations for their own pecuniary gain rather than to meet the needs of the community, and absented themselves from direct involvement in the daily efforts of their employees.

THE LEISURE CLASS

To understand why Veblen, and other heterodox economists after him, saw analysis of economic change from an evolutionary approach as crucial to understanding the dynamics of any economic system, we will look at his most important economic ideas in their appropriate context. Veblen wrote at a time when many social scientists (but few economists) were beginning to use evolutionary narratives to examine social phenomena. Veblen began his analysis of the economy with the concept of the "leisure class" which he singled out as "an economic factor in modern life." He presented this in his most famous book, *The Theory*

of the Leisure Class, which set forth many of the basic concepts of his analytical system, and made explicit use of his evolutionary understanding of the modern economy. The book was written as the excesses of the Gilded Age of the late nineteenth century began to reveal themselves in the form of the lavish entertainments and opulent mansions enjoyed by the wealthy capitalists of the era. However, Veblen began his analysis not with these wealthy robber barons, but with the feudal cultures of Japan and medieval Europe, because he believed that modern economic behavior had evolved slowly from those beginnings. In Veblen's view, any accurate social-science analysis had to carefully unearth the long historical roots of our modern institutions. (Lerner 1976, 22)

A common theme ran through economic history, according to Veblen: "Wherever the institution of private property is found, even in slightly developed form, the economic process bears the character of a struggle between men for the possession of goods." (Veblen 1973, 34) The word "struggle" conveys Veblen's view of competition—not merely placid price competition of the sort described by Smith, but the "slash and burn" competition more common in our modern business landscape. Veblen also recognized that property had held a dual role throughout history: one economic, one symbolic.

In that struggle for subsistence, according to Veblen, there has always been a "warrior" or "leisure class" and a "menial" or "productive class." This taxonomy is similar to the class distinctions made by Marx. The leisure class first emerged in early hunter-gatherer societies. Veblen defined this group as the class of persons exempt from menial labor and for whom the "honorable employments" of hunting were reserved. (Veblen 1973, 21) In these early cultures, the gender division of labor between men and women was strictly observed: the men hunting for food, the women gathering and farming and preparing the food. Both sets of activities were, of course, equally indispensable to economic survival, but not equally honored.³ The hunters constituted the first leisure class: "in [the hunter's] own eyes, he is not a laborer, and he is not to be classed with the women in this respect; nor is his work to be classed with the women's drudgery, as labor or industry." (Veblen 1973, 23)

Over time, the leisure class came to include the entire class of persons who were exempt from the more routine and menial tasks necessary for economic survival; the leisure class was not exempt from all work of any kind, but was instead exempt from menial labor. These invidious distinctions between different lines of work have persisted over time, Veblen insisted, meaning that our modern ranking of methods of making a living is rooted in our deep anthropological past. While a modern industrial economy no longer depends on a class of hunters to provide a large portion of society's means of subsistence,

the higher honor accorded those engaged in “predatory” pursuits has endured, and the low repute accorded those engaged in actual productive work has also persisted. The modern day robber barons were, in Veblen’s analysis, the economic descendants of the warring nobles of medieval Europe and the warrior class of Japan, struggling not against nature or against other clans for control over land and property, but against other robber barons for control of their industries. We can see similar struggles today. The U.S. government’s antitrust trial against Microsoft in the 1990s exposed Bill Gates’ ruthless tactics to increase use of Microsoft’s Internet Explorer (IE) and prevent new competition from threatening its monopoly, such as forcing computer manufacturers to install IE on their computers or withholding Windows from manufacturers who were building competing operating systems. Similarly, when faced with foreign competition in the 1970s, the U.S. auto industry used its political clout to lobby for protectionist measures, and ignored the emerging demand for quality small cars because they were not sufficiently profitable in the eyes of the Big Three. It is evident to all industry observers that the bankruptcies of GM and Chrysler in 2009 originated not in the spike in oil prices that preceded these actions three years earlier, but in the several decades worth of decisions to manufacture large gas guzzlers and to lag behind in the best technology that finally caught up with these famous brands.

In the Veblenian system, then, the modern leisure class consists of those whose ownership of wealth and whose control of the means of production permits them to engage in the same kind of relentless competition and predatory activity carried out by their barbarian forefathers, and more importantly, to be exempt from the menial jobs performed by ordinary workers. Modern leisure-class activities include investment banking, corporate law, management, and other activities undertaken by those concerned mainly with “conversion of goods and persons to [their] own ends, and a callous disregard of the feelings and wishes of others, and of the remoter effects of his actions.” (Dorfman 1961, 184) The modern menial class thus consists of those who are not owners of property and thus must work for someone else to obtain wages or salaries.

For Veblen, the leisure class was also the wealthy class, and that too has historical precedents. In ancient cultures, Veblen believed that wealth came to be equated with social status: as he argued, “possession of wealth confers honor.” (Veblen 1973, 35) Initially, wealth consisted of the booty dragged back from wars with neighboring clans or nations; the items seized, be they treasures or slaves, were the spoils of battle and therefore served as a very public sign of physical prowess. Possession of wealth came to represent “a trophy of successes scored

in the game of ownership carried on between the members of the group.” (Veblen 1973, 36-7) Over time, mere possession of wealth came to confer reputability on the possessor, as if the wealth itself signified the superior strength of the leader of the household. By the late nineteenth century, as Veblen was constructing his theories, robber barons such as Rockefeller, Vanderbilt, and Morgan were considered both successful and honorable largely because they were wealthy, despite their destructive and often dishonorable business practices. Moreover, ownership of property came over time to be seen as an indication of the prowess of the owner. With wealth thus equated to esteem, humans strove to emulate and surpass the wealth of their neighbors. Veblen concluded, “[I]t becomes indispensable to accumulate, to acquire property, in order to retain one’s good name....A certain standard of wealth in one case, and of prowess in the other, is a necessary condition of reputability, and anything in excess of this normal amount is meritorious.” (Veblen 1973, 37-8)

CONSPICUOUS CONSUMPTION

Of course, mere possession of wealth does not confer upon the possessor an honorific position in society unless the rest of society perceives that wealth. Therefore, the wealthy must engage in “conspicuous consumption.” Conspicuous consumption was an important element of Veblen’s understanding of human behavior. To quote Veblen at length on this point:

The quasi-peaceable gentleman of leisure [by which Veblen means the modern robber baron ‘descended’ from the early warrior], then, not only consumes of the stuff of life beyond the minimum required for subsistence and physical efficiency, but his consumption also undergoes a specialization as regards the quality of the goods consumed. He consumes freely and of the best, in food, drink, narcotics, shelter, services, ornaments, apparel, weapons and accoutrements, amusements, amulets, and idols or divinities. ... Since the consumption of these more excellent goods is an evidence to wealth, it becomes honorific; and conversely, the failure to consume in due quantity and quality becomes a mark of inferiority and demerit. (Veblen 1973, 64)

Conspicuous consumption is the way the wealthy demonstrate their wealth, and thus their success in war—or in business. By purchasing the finest houses, autos, suits and shoes—all visible and public signs of financial success—they gain the respect and admiration of their peers and subordinates. Today, the BMW parked outside the office, the Armani suit for everyday wear, and the Kate Spade handbag slung casually across

a shoulder, tell the casual onlooker that the owner is a successful (i.e., wealthy) person.

Veblen referred to this as “conspicuous waste” because, “in order to effectually mend the consumer’s good fame, [a conspicuous expenditure] must be an expenditure of superfluities.” (Veblen 1973, 77) Those expenditures are “traceable to the habit of making an invidious pecuniary comparison”—to demonstrate the level of income and wealth held by the conspicuous consumer. (Veblen 1973, 79) In other words, the Lexus owner would be as ably transported around town by a Ford, or the Mercedes SUV owner would have his or her needs just as efficiently and dependably met by a Chevy truck. The point of making an expensive purchase is precisely to demonstrate to those who cannot afford the Lexus or the Mercedes the superior social status of the conspicuous consumer. Robert Frank recounted, in his book, *Luxury Fever*, how some “nouveau” millionaires in both Silicon Valley and suburban Chicago have demolished large modern homes, valued in the hundreds of thousands of dollars, so they could build even larger homes on the same sites to suit their elevated social status. As one new executive for America Online declared, the “scrapper” that he razed “was definitely livable. I just wanted something bigger.” (Frank 1999, 28-39)

While luxury SUVs or demolition of perfectly good homes carried on by the wealthy may be obvious examples of waste, Veblen even disparaged those forms of conspicuous waste that were practiced on a daily basis. Conspicuous waste in his view was anything that did not contribute to a “fuller unfolding of human life.” (Veblen 1973, 94) For instance, Veblen argued that our tendency to prefer hand-wrought items to machine-made goods was based on the honorific status imparted by the costlier, hand-made item. In other words, our preference for a hand-crafted spoon over an ordinary spoon found in a typical diner was not based on the beauty of the hand-crafted item, but rather “a gratification of our sense of costliness masquerading under the name of beauty.” (Veblen 1973, 79) Veblen himself was reported to have once received as a gift an expensive brooch from a woman student who had become alarmed at his habitual use of a safety pin to hold together his jacket. When presented with the gift, Veblen simply chided, “You haven’t listened to a word I have said all semester.” (Dorfman 1973)

PECUNIARY EMULATION

Mainstream economic theory has long taught that consumers make purchases based on rational assessment of the intrinsic utility of the item in question. Veblen rejected that analysis as excessively simplistic in one of his most famous paragraphs:

The hedonistic conception of man is that of a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact. He has neither antecedent or consequent....Self-imposed in elemental space, he spins symmetrically about his own spiritual axis, until the parallelogram of forces bears down upon him, whereupon he follows the line of the resultant. When the force of the impact is spent, he comes to rest, a self-contained globule of desire as before. (Veblen 1919, 75)

The mainstream theory of consumer choice reduces all of the complex processes and influences involved in human consumption to a simple and overtly rational choice. The mainstream preconception is that products generate utility, e.g., that the smoker derives utility from consumption of his or her cigarette and has weighed the obvious costs of smoking against the benefits. Consumer tastes and preferences are then taken as given, with the relative price being the main factor that causes consumers to buy more or less of some commodity, such as cigarettes or shoes. Veblen recognized that this approach ignored the myriad social influences on consumption: advertising, peer pressure, the symbolic nature of commodities in a consumerist culture, and many other external influences.

In particular, Veblen argued that mainstream economics ignored a powerful motive for consumption, the motive of pecuniary emulation: the imitation of the spending habits of our peers and those above us on the social ladder. As Veblen argued, “Goods are produced and consumed as a means to the fuller unfolding of human life....But the human proclivity to emulation has seized upon consumption of goods as a means to our invidious comparison.” (Veblen 1973, 94) Consumption decisions are driven by the need to fit in with our peers or, in popular parlance, to keep up with the Joneses. Again, to quote Veblen:

[T]he standard of expenditure which commonly guides our efforts is not the average, ordinary expenditure already achieved; it is an ideal of consumption that lies just beyond our reach....The motive is emulation—the stimulus of an invidious comparison which prompts us to outdo those with whom we are in the habit of classing ourselves...each class envies and emulates the class next above it in the social scale, while it rarely compares itself with those below or with those who are considerably in advance. (Veblen 1973, 81)

Veblen thought that this “propensity for emulation” was among the strongest economic motives. Juliet Schor confirms that this motive still dominates in our modern era in her 1998 book, *The Overspent American*.

The ubiquitous “visible logo”—be it the Nike swoosh, the Hilfiger label, or even the Starbucks name on a disposable paper cup—tells observers that the purchaser has bought the real deal. (Schor 1998, 46) One nationwide poll of women revealed that half of the respondents participated in status buying, with 80% of the respondents—a percentage that would not have surprised Veblen at all—admitting that purchases were more often based on the designer label than on the intrinsic quality of the goods.

Veblen’s argument that conspicuous consumption and pecuniary emulation are the driving forces behind much of the consumption we observe in capitalism is persuasive. But Veblen should not be interpreted as condemning *individuals* who engage in these behaviors. This is true for two reasons. First, human beings are social beings and we cannot help but to emulate much of the behavior of those around us, and in fact, to try to outdo others. (Lerner 1976, 24) Second, and perhaps more importantly, pecuniary emulation, or our emulation of the spending habits of our peers and those above us on the social ladder, takes place in a context of capitalism. In capitalism, social status is heavily tied to income and wealth, and is demonstrated visibly by the accoutrements of wealth—fancy clothes, luxury cars, and stately houses. To maintain our status in our desired communities, we endlessly strive to “keep up with the Joneses.” Imagine for a minute the businessperson who arrived at an important meeting in a polyester suit, wearing coke-bottle glasses and carrying papers in a plastic shopping bag rather than in an expensive leather briefcase. Would he or she be given the same attention at that meeting, or receive promotions in due course? Similarly, the student who wanted to join the most popular sorority or fraternity on campus, but showed up for rush events in rumpled sweats and dirty sneakers would most likely be hastened out the door. While both individuals might have much of substance to contribute, their outward appearance would signal their desired peers that they just wouldn’t fit in.

As we have seen, Veblen’s analysis of personal consumption in capitalist societies is essentially that consumers are human beings influenced strongly by the ethos and practices of the social order in which they live. That is, to the question of how consumers behave, the answer is, at least in large part: “It depends on where they are and the leisure class they are trying to emulate.” This conclusion is at odds with the assumption in mainstream economics—discussed in Chapter 1—that human beings in all societies during all of history have maximized joys from buying things, exercising unwavering rationality. Fortunately, in recent years there has emerged a school of thought to the side of the mainstream called “behavioral economics” (see box, pp. 101-102). It is clear that its proponents are treading on a path worn first by Veblen, whether they know it or not.

BEHAVIORAL ECONOMICS: A New View of Human Decision-Making

The emerging field of behavioral economics has provided a promising alternative to the standard mainstream economic theory of rationality as it pertains to human decision-making. It is noteworthy that the two pioneering figures in the field, Daniel Kahneman and Amos Tversky, were trained in psychology rather than economics. In his recent best-seller, *Thinking Fast and Slow*, Kahneman described his reaction to his first exposure to the rational economic agent: [Upon reading that] "[t]he agent of economic theory is rational, selfish, and his tastes do not change; I was astonished. . . . To a psychologist, it is evident that humans are neither fully rational nor completely selfish, and that their tastes are anything but stable" (Kahneman 2011, 269).

In his book, Kahneman describes how he and Tversky began their foray into the psychology of economic behavior through an examination of risky decision-making, but eliminated the standard assumption of rationality. The result was their first article together, "Prospect Theory: An Analysis of Decision under Risk," in which they found that individuals will likely react more intensively to potential losses than to potential gains (Kahneman 2003, 164), outcomes that in a purely utilitarian and rationalistic sense should be weighed equally. Other insights deriving from these first forays include the finding that most individuals in the real world tend to value expected financial outcomes more highly than they assess the less obvious—but equally significant—opportunity costs. One such study examined why New York cab drivers tend to work fewer hours on rainy days when they could presumably reap many extra fares from pedestrians seeking refuge from the precipitation (cited in Kahneman 2003, 164). In standard economic theory, rational utility-maximizing cab drivers should choose to work fewer hours on sunny days, then make up for the income foregone by working longer hours on rainy days. However, the study in question (Camerer, *et al.*, cited in Tetlock 2002, 95) found that cab drivers typically set a target income for the day which obliges them to work extra hours on sunny days, but allows them to knock off early on rainy days when their services are in such demand. This may explain why it is so hard to find a cab in bad weather!

Kahneman and Tversky's pioneering 1979 article was submitted to *Econometrica*, rather than to a psychology journal, so as to initiate a dialogue with their fellow social scientists. From this early work has come a burgeoning field of behavioral economics, including behavioral microeconomics, behavioral finance, and related fields such as neuro-economics, where neuroscientists examine actual brain activity as individuals make decisions. Matthew Rabin's important 1998 review of the behavioral economics literature lists some insights from psychology that have been incorporated into behavioral economics models, including: the dependence of individual utility on past consumption or expected future consumption rather than on an assessment of a neutral state of consumption; the tendency toward "status quo biases," i.e., the tendency of humans to prefer their current known but perhaps unsatisfactory circumstances over potential future gains that are likely to be accompanied by other future losses; and the role of fairness and altruism as they affect our assessment

of the outcomes of both market and non-market exchanges. For example, a behavioral economics model could demonstrate that cutting an employee's wage would be seen by these employees as unfair, even if such an outcome could be construed as optimal for the firm (Kahneman 2003, 165).

This debate over rationality is more than just a theoretical academic discourse between economists and psychologists. It has already had real policy implications. The assumption that humans are rational and always able to maximize their utility has influenced many of our policy makers in recent years, particularly those influenced by the Chicago School of economics, to favor market solutions to all sorts of problems. As Kahneman recounts, "faith in human rationality is closely linked to an ideology in which it is unnecessary and even immoral to protect people against their choices. Rational people should be free, and they should be responsible for taking care of themselves" (Kahneman 2011, 411). In other words, some libertarian social policies are derived at least in part from the principle that citizens are rational, or at least that they ought to be. On that basis, many policy makers have argued, for example, for the government to replace its traditional social insurance programs with health savings accounts or individual retirement accounts so as to empower individuals to make better choices.

Kahneman and some other behavioral economists, given their skepticism about the rational actor, advocate a kind of "libertarian paternalism," as he calls it. Along these lines, Cass Sunstein and Richard Thaler argue, in their book *Nudge*, that the state has an important role in framing decisions for individuals so as to "nudge" them in the right direction. The Sunstein/Thaler approach recognizes the high likelihood of loss-aversion behavior; and their ideas have been incorporated into real-world policy prescriptions, e.g., automatic enrollment in pension plans, less misleading labeling of foods, and more accurate MPG information for new cars (Kahneman 2011, 372, 414-415), which either make the socially desirable decision the default decision for individuals or provide better "choice architectures" for decision-making by consumers. Kahneman concludes his book by quite reasonably asserting that, unlike the idealized rational actor in mainstream economics, humans "need protections from others who deliberately exploit their weaknesses" (Kahneman 2011, 413). In bringing his and others' insights about the human psyche to economics, Kahneman has opened a useful dialogue that may one day unify rather than divide the social sciences in their explorations of the myriad facets of human behavior.

Additional Reading:

Kahneman, Daniel, "A Psychological Perspective on Economics," *American Economic Review*, Vol. 93, no. 2 (2003): 162-168.

Kahneman, Daniel. *Thinking Fast and Slow*. New York: Farrar, Strauss, and Giroux, 2011.

Rabin, Matthew, "Psychology and Economics," *Journal of Economic Literature*, March 1998: 11-46.

Tetlock, Philip E., and Barbara Mellers, "The Great Rationality Debate: Choices, Values and Frames by Daniel Kahneman and Amos Tversky," *Psychological Science*, Vol. 13, No. 1 (January 2002): 94-99.