and the book project was born. Its title emerged from a 2012 seminar at the Center for the History of Political Economy at Duke University, where Bruce Caldwell kindly invited me to outline my book venture for critical discussion. During a rerun of the course in 2012 at Shandong University, the students remained enthusiastic and even corrected some flaws in my argument. I also received helpful feedback from students who attended a fuller series of lectures based on the book given at the Université Paris I Panthéon-Sorbonne in early 2014. Among the many who have helped me with discussions and comments are Richie Adelstein, Amitai Aviram, Christian Barrère, Jens Beckert, Peter Boettke, Marcel Boumans, Robert Butler, Bruce Caldwell, Ana Castro, Rutger Claassen, Michael D. Cohen, Jean-Philippe Colin, Frank Currie, Hulya Dagdeviren, John B. Davis, Simon Deakin, Frank Decker, Christine Desan, Ronald Dore, Gary Dymski, Christoph Engel, Chukwunonye Emenalo, Steve Fleetwood, Nicolai Foss, David Friedman, Francesca Gagliardi, Pierre Gervais, David Gindis, Charles Goodhart, Avner Greif, Jerry Hough, Anne-Claire Hoyng, Kainan Huang, Geoffrey Ingham, Thorbjørn Knudsen, Richard Langlois, John Linarelli, Richard Lipsey, Vinny Logan, Tariq Malik, Renate Mayntz, Deirdre McCloskey, Perry Mehrling, Claude Ménard, Philippe Minard, Zhihong Mo, Paolo Moreira Franco, Grimot Nane, Guinevere Nell, Richard Nelson, Klaus Nielsen, Bart Nootenboom, Ugo Pagano, Katharina Pistor, Bharat Punjabi, Ernesto Scapatti, Itai Sened, J.-C. Spender, Robert Steinfeld, Rolf Steppacher, Virgil Storr, Arthur Stinchcombe, Wolfgang Streeck, Andrew Tylecote, Richard Van Den Berg, Derek Wall, Randy Wray, Xueqi Zhang, and anonymous referees.

I am grateful to the Association for Evolutionary Economics, Edward Elgar Publishing, and the Cambridge Political Economy Society Trust for permission to use material from published articles in chapters 3, 5, and 7.

Throughout the text, all emphases in quotes are in the original, unless otherwise noted.

Introduction

The Great Financial Crash of 2008 and the subsequent global crisis have led many people to question the viability of capitalism or to consider major reforms to its financial and corporate institutions. Alongside this, spectacular economic growth rates in China, India, and elsewhere since 1980 have revealed the potential dynamism of private enterprise and markets as well as the role of strategic guidance by governments. We need to understand the nature of capitalism, the sources of its dynamism, and its frailties.

The word *capitalism* was once unfashionable, except among opponents to that system. That has changed. In 2012 the words *capitalism* and *socialism* were the two most consulted entries in the Merriam-Webster online dictionary (Merriam-Webster 2012). This book addresses capitalism, with a much shorter critical discussion (in chapter 12) of socialism.

Readers looking here for an ideological tract, either for or against capitalism, will be disappointed. Although I consider the future of capitalism near the end of this volume, my main purpose is to understand the nature of the beast and to establish some conceptual tools to dissect its inner structure. I shall also argue that some mix of market competition and state regulation is unavoidable in any complex modern economy, thus disappointing advocates of unfettered market competition and of socialism (at least as originally defined). Some further policy questions are raised in chapters 15 and 16—particularly the thorny problem of inequality. But generally the book is more about understanding capitalism than policy. Consequently, for example, analysis of the post-

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1. They were followed, incidentally, by touché, bigot, marriage, democracy, professionalism, and globalization.
1970s rise of neoliberal ideology is consigned elsewhere (Crouch 2011; Mirowski 2013).

Although recent events and developments are mentioned, the book does not focus on them. Instead, it addresses the nature of capitalism and its possible future in the twenty-first century. The supreme purpose is to understand what capitalism is and to establish it as a historically specific and relatively recent phenomenon. It is neither a historical analysis nor an exposition of models. There is no new theory of its origins here, and I do not develop a new analysis of capitalist growth or development.

Instead, I point to the explosion of growth that started in Europe in the eighteenth century and try to identify institutional developments that preceded or coincided with this expansion. Thereby some possible causes are suggested: future empirical work by economic historians will have to test their relative significance. But no empirical inquiry can start without some initial identification of key institutional developments that make up the modern order. This is not a trivial task.

The Contribution of This Volume in Brief

There are many books on capitalism: so what is added here? My position is different from both Marxism and much promarket libertarianism. This is apparent from my overall analytic approach, including my assessment of the constitutive role of law and the state within capitalism, my conceptual treatments of property and capital, and my appraisal of postcapitalist possibilities. From diametrically opposite policy positions, both Marxism and promarket libertarianism focus on markets. But just as important within modern capitalism is the role of property as collateral, to secure loans for enterprise. Specific legal and financial institutions are needed to make this possible, yet in many accounts of capitalism they are omitted.

Many define capitalism as private ownership plus markets. This loose definition fails to focus on the key features of the modern dynamic epoch. By most definitions, markets and private property are much older than capitalism, as it is defined here. If capitalism is a particular historical formation, then we must identify its essence more precisely. I argue that private ownership and markets are necessary but insufficient to define capitalism.

Some advocates of capitalism downgrade its distinctive features. By treating capitalism as (nearly) universal, they blur the boundaries of this historically specific system. Many see contractual exchange as a "natural" phenomenon. For one famous writer, all human action is "exchange." He and others see production as an "exchange with nature." Some treat politics as a matter of individual contract and exchange, thus viewing all power and authority as commerce. Every activity becomes an exchange, and delimited notions of commerce lose their meaning. Simultaneously, the concept of contract is itself devalued by notions of "psychological contract" or "implicit contract" that may involve neither individual consent nor legal enforceability. Capitalism is equated with markets, which in turn are regarded as synonymous with exchange. Some leading authors favor a "market for ideas" (treated as synonymous with freedom of expression), overlooking whether ideas are actually owned, bought, or sold (and maybe suggesting markets as the solution to almost every problem). Firms too become markets. Everything is a market. Markets and contracts become omnipresent. As terms, market and contract too lose their meaning. Against these degradations of our conceptual armory, an appraisal of the virtues and vices of capitalism requires a superior conceptual framework that is more sensitive to great institutional innovations in history.

In short, the language required to understand capitalism has been deeply corrupted by economists and other social scientists. Vital concepts—including law, property, exchange, markets, and capital—have become so degraded that mainstream, Marxist, and other approaches have difficulty identifying the core unique features of capitalism. A new understanding is required that builds on redefined concepts. Relatedly, the physicalist metaphors that underlie much of economic analysis have to be discarded for more adequate and illuminating alternatives.

Mainstream economics has further analytic problems in dealing with capitalism. Central to some prominent definitions of capitalism are institutions such as money and firms. But both are treated poorly. As Frank Hahn (1965, 1980, 1987, 1988) explained, general equilibrium theory cannot explain why agents hold on to money. If we follow Keynes (1936, 1937) and regard money as a means of dealing with uncertainty about the future, where uncertainty by definition refers to future events concerning which "there is no scientific basis on which to form any calculable probability whatever" (Keynes 1937, 215), then mainstream economics again proves inadequate because it has banished this concept of
uncertainty from its discourse (Hodgson 2011a). I argue later that the concepts of capital in mainstream economics and in Marxism are also deficient. Turning to the firm, Frank H. Knight (1921, 271) argued that its existence is also “the direct result of the fact of uncertainty.” A similar explanatory emphasis on uncertainty is endorsed by others, including accounts that rely on transaction costs (Loasby 1976; Dahlman 1979; Kay 1984; Langlois 1984). By downplaying uncertainty, mainstream economics also lacks an adequate explanation of the existence of the firm. Mainstream thinking has severe limitations in coping with core capitalist institutions such as money, markets, capital, and firms.2

I argue that, while markets are central to capitalism, capitalism is not simply a market system: unavoidably it contains different subsystems of governance, production, distribution, and exchange. Furthermore, capitalism cannot in principle have markets for everything or bring everything within the orbit of commodity exchange.

In particular, under capitalism there can never be a complete set of markets for future labor power. For there to be full futures markets for labor, all workers must enter into contracts for their expected working life. This would be tantamount to voluntary bondage, limiting the freedom of workers to quit their employment. Paradoxically, pushing markets to their limits would mean the return of slavery for the workforce.3 Unlike owned capital, free labor power cannot be used as collateral to obtain loans for investment. At least in this respect, capital and labor do not meet on a level playing field, and this asymmetry is a major driver of inequality.

A further consequence of missing markets for future labor power was identified by the great economist Alfred Marshall (1920, 565). Marshall pointed out that, if the employer spends money on employee training and skill development, this investment cannot be secured by futures contracts and will be lost to the employer if the worker quits. As a re-

2. This exposes the limitations of MacKenzie’s (2006) “performativity” thesis—that economics creates the phenomena it describes. Of course, many ideas from economics have changed the real world. But mainstream economics comprehends some features of capitalism so poorly that it cannot be primarily responsible for their erection. For further criticisms of the performativity thesis, see n. 5, chapter 2 below, and Hodgson (2010c).

3. Some libertarians—such as Nozick (1974)—have argued that voluntary slavery should be permitted. This goes with the assumption that the individual is always the best judge of his or her interests and that these judgments where possible should be honored. See Hodgson (2013b) for a critique of this assumption.

result, without compensatory arrangements or incentives, employers will underinvest in human learning and education.

These missing markets and factor asymmetries are central to capitalism, but they are rarely discussed by modern economists. We need to look more closely at the system that dominates our world.

Despite the 2008 crash, most economists still seem more interested in mathematical technique than the big questions about modern capitalism.4 Mathematics is an indispensable tool. But the dominance of mathematical technique in contemporary economics has crowded out valuable discourses seeking conceptual understanding of and precision concerning capitalism and other economic formations. Mathematics is said to bring rigor. But conceptual precision is also needed. Unfortunately, economists are not trained to be meticulous about concepts. Many do not even try. Mathematics involves symbolic constructions of beauty and finality. The task of conceptual precision is no less tough but much messier. It is always unfinished.

Theorists of Capitalism

Inspirational thinkers that have helped us understand capitalism include Karl Marx, Max Weber, Joseph A. Schumpeter, John Maynard Keynes, and Friedrich A. Hayek.5 Over 150 years ago, Marx rightly predicted the global spread of capitalism. There has been a revival of Marxist thinking since the Great Crash of 2008, and much discourse on capitalism is unavoidably influenced by Marx. His contribution is magisterial. But, for reasons that I discuss in this book, I find Marxist and other approaches inadequate and invalid in key respects.

Marx put less emphasis than Schumpeter and others on finance, and, where he did so, he was burdened by a flawed substance theory of money,

4. The preoccupation of economists with mathematical technique over real-world substance has been criticized by Krueger (1991), McCloskey (1997), Blaug (1997, 1998), Friedman (1999), Krugman (2009), and many others. But I do not concur with Lawson’s (1997) argument that mathematics is ruled out by the open and complex nature of economic phenomena (Hodgson 2006a, 2012).

5. Hayek (1973, 61–62) disapproved of the word capitalism because before the 1970s it was largely used by critics of the system. He wrote instead of the “free system” and the “Great Society.” Clearly he was referring to a system dominated by market exchanges and individual private property.
where money was treated more as a substance such as gold and less as a system of shared rules, representations, and understandings. He was also impaired by the labor theory of value, which he inherited from Adam Smith and David Ricardo. Centering his account on the class struggle between workers and employers and on the role of labor as the circulating blood of the capitalist body, he gave relatively less attention to the dynamic combinations of finance, knowledge, and innovation.

Both Marx and Schumpeter were mistaken in regarding the evolution of the system as one of unfolding primarily or exclusively “from within”—from its own economic core. The development of individual capitalist systems is important, but capitalism must also be understood as a global, interacting population of different national formations, each with different types of subsystems. Furthermore, capitalism is always conjoined with state power. Marx and Schumpeter paid insufficient attention to the constitutive and economic roles of the state and to capitalism’s political and legal nature.

While Schumpeter rightly emphasized the driving forces of money capital and finance, he saw the rhythms and crises of the system as resulting from inner, multiple-frequency cycles rather than from the interactions between different capitalisms or between different subsystems. Both Marx and Schumpeter failed to underline the role of collateralizable property in the creation of finance for enterprise.

Hayek and other Austrian school economists provided an invaluable understanding of the nature and role of knowledge and markets in economic systems, despite their insufficient appreciation of capitalist institutions and the role of the state and their challengeable theory of money. From a very different policy perspective, John Maynard Keynes remains extremely important, particularly for his understanding of money, the fragility of markets, and the consequences of uncertainty.

Weber understood the role of the state and a “rational legal system” in capitalism. I also acknowledge the influence of others from the German historical school, including Albert Schäffle, Gustav Schmoller, and Werner Sombart. Members of this school understood long ago that neither laissez-faire nor wholesale planning would work and that the way ahead was a reformed and regulated capitalism that protected property and stimulated innovation.

No less important are the original American institutionalists, particularly Thorstein Veblen and John R. Commons. Although they lacked a comprehensive theory, they enhanced our understanding of the institutional and legal foundations of capitalism and also emphasized the role of technology in revolutionizing social life. I also draw on the work of other mainstream and heterodox economists as well as that of historians, sociologists, anthropologists, psychologists, philosophers, political scientists, and legal theorists.

### Key Aims of This Work

Given the primary aim of understanding the essence of capitalism, matters of extensive historical exegesis and detailed empirical description are omitted. But of course we must rely on crucial facts of history, and of different capitalisms in time and space, to achieve this primary mission. This is not a book of economic history but one that relies on economic history and comparative analysis to reach a clarificatory and analytic goal.

This foremost objective gives rise to a number of other aims. While private property and markets are among the key defining institutions of capitalism and vital sources of its historically unprecedented dynamism, I argue that capitalism, property, money, markets, and corporations typically depend on, and are partly constituted by, the state. This does not simply mean that the state is necessary to correct “market failures” or that empirically the role of the state has been important. The state was vital to bring capitalism into being and is needed to sustain its
existence. As Dani Rodrik (2011, xviii) argued: “Markets work best not when states are weakest, but when they are strong.”

This again puts me at loggerheads with many libertarians and Marxists. Despite their different political standpoints, they share the view that markets and private property can be understood with minimal reference to the state. For libertarians, the system is essentially a “spontaneous order,” and state planners or designers play a secondary or even inessential role. For most Marxists, the system consists of economic relations between antagonistic social classes; the state is there mostly to represent the bourgeoisie and to keep the working class under control. The state and law are seen as part of the superstructure, but not of the “economic” base. There are nuggets of truth in both standpoints, but together they downplay the vital and constitutive role of law and the state.

It is not that any state will do. Crucial is the role of law. For capitalism to prosper, the state has to sustain and operate within an effective legal framework. Here again I counter leading libertarians who argue that law is essentially custom and does not necessarily require something like a state. Others argue that what matters is control or possession: not legal rights established by statutory courts and state legislatures. For example, Armen Alchian (1977, 238) defined a “property right” as the probability that a decision over use will be effective. Oliver Williamson (1985a, 184) argued explicitly that “transaction cost economics” should address “private ordering” rather than legal institutions such as courts.

Marx argued that law is part of the “superstructure” and focused instead on the underlying “relations of production” that make up “the economic structure of society, the real foundation.” But how these vaguely defined “relations of production” (presumably involving property, rights, and rules) can be understood without immediate reference to law has always been a mystery to me. If social classes are defined in terms of ownership of the means of production or as employees of owners, then legal concepts such as the employment contract and property ownership are essential to these definitions. Reference to law is primary and essential.

8. Some Marxists and post-Marxists attempt to rescue Marx from his cruel and unacceptable formulations. I respect these efforts but ask why they wish to retain their “Marxist” affiliation? The answer, I speculate, may lie in a desire to maintain the political project to replace capitalism with socialism. If so, it would have more to do with ideology than science.

Law is a central mechanism of social power, and Marxists unconvincingly regard it as secondary.

In economics and sociology, law is often vaguely described as formal and then pushed aside, as if it were no part of the rules and relations of vital social organizations such as the firm and the family. An amazing consensus—treating law as epiphenomenal rather than constitutive—pervades the social sciences. But it has remarkably little supporting argument. In contrast, I argue that rules and relations constitute social reality and that some of the most important and powerful social rules are legal and statutory in nature.

Of course, an unenforced law or right is not an operative social rule in fact. But, when the rule of law prevails and laws are enforced, these become powerful social rules. They are backed by authority and have the perceived legitimacy of sovereign power. Transgressors face possible punishment. Much of the de jure then becomes de facto.

Taking law seriously does not mean ignoring rules and practices that are undefined in law. The “informal” norms of culture and convention also matter greatly. When law is nonexistent or ineffective, they are everything. And, even when law is strong, there are zones of discretion where much else is important. The fact that legal rules determine far from everything does not mean that law can be ignored.

Law is not treated here as a set of statements or statutes in dusty books. Laws are made meaningful and have effect within legal institutions, including those of legislation, judgment, and enforcement. The legal focus here is on institutional facts, not proclamations alone.

Downgrading law does not simply mean that a crucial function of the modern state is neglected. The accounts of Marx, Alchian, Williamson, and others are inadequate in terms of human motivation as well. There is no recognition of legally sanctioned rights, and everything becomes a matter of mere possession. The individual is treated simply as a “pleasure machine,” simply seeking the use of things to maximize his or her utility. Missing here—as highlighted by Adam Smith—are impulses to behave morally, respect authority, and seek justice alongside greed and the quest for pleasure (Hodgson 2013).

The demotion of law and the conflation of property with mere possession cannot be defended on the grounds that they are sufficient to understand or predict behavior. To some degree, people take account of rules concerning justice and morality, even if their supreme motive is greed.
To understand capitalism we need a fuller account of multifaceted human nature. But this does not mean that capitalism is simply a reflection of the latter. Instead, it is a specific system with the capacity to harness human dispositions in a particular manner.

My third aim is to counter the still-widespread view that capitalism is an eternal or natural order. Along with Marx, the historical school, the original institutionalists, and others, I argue that capitalism is a relatively recent phenomenon. Capitalism is much younger than the state: it requires special forms of state that cannot confiscate property arbitrarily at will, that are effectively restrained by laws, that have internal checks and balances, and that are faced with countervailing (democratic or other) powers that help protect a relatively autonomous legal system. Such states are necessary to legitimate and protect property rights and to enforce contracts. They required peculiar circumstances and a long time to evolve. Foreshadowed in the Italian city-states, they did not appear on a national scale until the seventeenth century, in Britain and the Netherlands.

My fourth aim is to develop workable definitions of capitalism and of its constituent institutions. To do this, I must counter academic habits of neglect concerning definitional tasks. Lamentably few social scientists these days have a solid grounding in philosophy, including the philosophy of their own discipline. Many in my experience cannot distinguish acts of definition from those of abstraction or description. Many seem to believe that adequate definitions will emerge with little reflection, during or after some process of empirical investigation: strew the facts, and definitions will congeal. But all inquiry is theory driven: it requires conceptual guideposts, all of which depend on prior definitions.

As an example, consider Thomas Piketty’s (2014) breakthrough work in Capital in the Twenty-First Century. The book is driven by forceful data and a little precise mathematics, so why do we need to care about concepts and definitions? The truth is that Piketty had to reverse more than two centuries of abuse of the notion of capital by economists and sociologists to make his case. After an age of terminological obscurationism, his data would have us return to the commercial meaning of the concept.\(^9\)

I have had arguments with eminent social scientists who, in post-

9. While Piketty (2014, 46) commendably removed inalienable assets such as “human capital” and “social capital” from his definition of capital, it still requires sharpening, as noted in chapter 7 below.
of the economic and political systems on the surface is apparent, not real. In fact, these systems are deeply intertwined.” I also concur with Bruce R. Scott (2009, 4) in his claim that capitalism is both “a political phenomenon” and “an economic one” and that “specifically it requires the visible hands of political actors exercising power through political institutions.” Capitalism always involves legal and political institutions; pure “anarchocapitalism” is an unrealizable fantasy.

Elements of Legal Institutionalism

The approach here differs from much of mainstream “law and economics,” which is often about utility-maximizing individuals acting under legal constraints. Relatively little is learned from law itself. The approach of legal institutionalism is different. It makes claims concerning the nature of social reality and (more complex) individual motivation, at least in modern, developed socioeconomic systems. It does not yet provide a full theoretical approach, but it does provide some tentative and limited indications concerning theory and policy.

In legal institutionalism there are three primary ontological claims. When addressing property rights many economists highlight agent-object relations, where objects are conceived in physical terms. Often neglected are agent-to-agent interactions that engender and sustain shared interpretations, meanings, understandings, rules, and institutional facts (Searle 1995). Among these many rules, and their matters of meaning and interpretation, are legal obligations and rights. Much economic activity consists of exchange, allocation, interpretation, or adjudication involving legal rights or obligations. An economy is much more than the physical creation, transformation, or transfer of material things.

The second ontological claim concerns the nature of law. It is argued that law (at least in the fullest and most developed sense) necessarily involves both the state (broadly construed to involve a realm of public ordering) and private or customary arrangements. Reduction of law to just one of these two aspects is mistaken. Law involves an institutionalized judiciary and a legislative apparatus.

The third ontological claim is that law—understood as an outcome of both state intervention and private ordering—accounts for many of the rules and structures of modern capitalist society. Consequently, law is not simply an expression of power relations but also a constitutive part of the institutionalized power structure and a major means through which power is exercised. This claim applies primarily to modern developed economies. In underdeveloped societies the rule of law may be compromised by greater arbitrary power. But, even in these cases, at least in the modern world, law still plays an important role.

Models of the spontaneous development of law typically rest on relatively small numbers of agents and underestimate the complexities and uncertainties in developed societies (Knight 1992; North 1994; Sened 1997; Mantzavinos 2001). Law is developed by organs of the state, including judges and legislatures. While it may often itself reflect customary experiences, it is a means of overcoming some of the complexity and uncertainty of multiple, complex, devolved interactions in large societies.

Legal institutionalism upholds an understanding of crucial legal rules is necessary for economists and other social scientists. This is not to say that law is everything. Many social rules are not laws. The law is necessarily incomplete and sometimes self-contradictory. There are important areas of social life that rely on frequent interpersonal action rather than the anonymous generalities of law. Nevertheless, in analyzing modern capitalism an understanding of the role of law is vital.

Legal institutionalism shares with other institutional approaches a common emphasis on the importance of social rules. Indeed, constitutive and procedural rules are the stuff of social life, and institutions are essentially systems of shared social rules. Legal institutionalism adds to this the further claim that many of the more important and powerful rules are legal in character and that they are backed by the power and authority of the state.

One immediate consequence of this vision is the literal impossibility of complete deregulation or of an unregulated economy or market. Rules are everywhere: they are vital for social and economic life. All that can be attained is to change some rules or to remove some to allow others to do more work. Rather than universal deregulation, legal institutionalism addresses the difficult research question of what kind of rules are appropriate for each particular circumstance. Given the com-
plexities involved, such an approach must be cautious and experimental and cannot proceed on the basis of complete prior design.

Legal institutionalism embraces a view of individual motivation that is much closer to Adam Smith with his “moral sentiments” than the unidimensional, utility-maximizing individual of modern mainstream economics. Individuals are often greedy and selfish, but there are also motives of morality or justice. To understand human behavior in society and business, this appreciation of morality and justice is just as necessary as one of greed and vested interests. All these factors help bind modern, complex, socioeconomic systems together (Hodgson 2013b; Smith 2013).

The role of authority is crucial, as dramatized in the famous experiments on obedience conducted by Stanley Milgram (1974). Some basic dispositions to obey authority are probably hardwired—a result of millions of years of evolution in social groups (Haidt and Joseph 2004, 2007). Law draws on these dispositions, along with feelings of morality and justice, to institutionalize authority within a system of law. We may follow customs out of habit or conformism, but in modern society law is too vast and complex to be obeyed simply by these means. Instead, we generally accept the authority of the law.

With this multidimensional view of human motivation it is impossible to separate the “economic” from the “legal.” Many people want to adhere to the law and also pursue their self-interest. Consequently, the attempt to make a distinction between “economic property rights” and “legal (property) rights” fails. Yoram Barzel (1997, 3) saw “economic rights” as related to “what people ultimately seek” and law as simply “the means to achieve” those ends. But many people want more than simply “the ability to enjoy a piece of property”—they wish to own it, as a recognized and legitimate right, with assurances that it has not been acquired illegally or immorally. As Smith (1759/1976a, 199) put it in his *Moral Sentiments*, alongside our greed and “self-love” we also consider “what is fit and proper to be done or to be avoided”. “It is thus that the general rules of morality are formed.”

Legal institutionalism also highlights the problem of corruption. Corruption has its apologists, such as those who claim that it oils the wheels of commerce or that, if it is done by mutual consent, it must be Pareto efficient (Huntington 1968). Especially in the context of bureaucracy and underdevelopment, corruption may seem to be the only way to get things done. Once again, this view assumes that markets and business naturally operate outside law and state institutions; law and regulation are seen to give rise to corruption because they increase the costs of commerce. But, from the perspective of legal institutionalism, corruption is the negation of legal ordering.

As noted in chapter 14, empirical studies indicate that corruption has deleterious effects on economic performance (see Shleifer and Vishny 1993; Mauro 1995; Jain 2001; Mo 2001; Aidt 2003; and Pellegrini and Gerlagh 2004). The social costs of corruption may be huge (Hodgson and Jiang 2007). They include the corrosion of the legal system in favor of elite interests and nepotism. Evidence shows that corruption stultifies effective economic competition, undermines investment, inhibits the rule of law, undermines effective state administration, and promotes political instability.

What has legal institutionalism in common with the original American institutionalism in economics (including Thorstein Veblen and John Commons) and with the new institutional economics (including Ronald Coase, Douglass North, Mancur Olson, Elinor Ostrom, and Oliver Williamson)? How does it differ from them?

The answers are complex because both institutionalisms have contained a diverse range of thinkers, with some important overlap between the two traditions (Dequech 2002; Groenewegen, Kerstolt, and Nagelkerke 1995). In recognizing the historical specificity of property, contract, exchange, and firms, legal institutionalism shares an important insight from the original institutionalism. Furthermore, the original institutionalist Commons placed particular emphasis on the role of law, which he regarded as a historically specific combination of both legal decree and custom. Other leading original institutionalists recognized the economic role of law, to differing degrees. The contribution of Veblen, for example, had more to do with the general nature and evolution of institutions, although he underlined intangible assets plus vital legal concepts such as property and incorporation (Camic and Hodgson 2011).

New institutional economists have made major contributions to the development of the interface between law and economics, but sometimes they have treated law as a matter of custom or private ordering alone. But, on the other hand, North, Wallis, and Weingast (2009) have stressed the general role of statutory law and of legal incorporation of business firms in particular.11

11. Underlying the overlap between parts of the original and the new institutionalism, the Nobel laureate Ostrom (2004) chose Commons (1924) as one of the ten most important
Legal institutionalism draws from all these traditions, but it gives particular emphasis to the role of the state in the legal system and to the constitutive role of law in modern socioeconomic life.

**Historical Explanations of Origins—
a Brief and Derivative Summary**

It is not the purpose of this work to examine the historical reasons for the emergence of capitalism. It is more concerned with the essence of capitalism. It uses history principally to identify when crucial institutional components of capitalism were established. But this clearly involves some preconception of what these components were. In identifying these particular institutions, I take capitalism as a relatively recent phenomenon and consider the rapid development of leading economies in the last few hundred years. By locating that takeoff, history helps us identify the key institutions that emerged and empowered the system.

The complex question of the origins of capitalism has long been debated by economic historians and others. I do not add anything new on that topic. A brief, eclectic account follows. As Jean Baechler (1975) argued, it is methodologically illegitimate to explain the origins of capitalism in terms of defining properties of capitalism itself. To do so would be to assume what has to be explained. The origins have to be understood in terms of factors outside the system's defining core, in terms of novel combinations of elements, or in terms of new institutions. Baechler (1975, 42) argued specifically that “the solution to the problem of the origins of capitalism must be sought within the political system.”

The importance of the state in the emergence of capitalism is already well established in numerous studies of law, property rights, markets, banking, manufacturing, and so on. A key factor was the development of a new and sophisticated state machine that was strong enough to protect property and trade, but adequately restrained by checks, balances, and countervailing power, to minimize confiscation or overtaxation, to protect a relatively autonomous legal system, and to allow the development of self-governing organizational forms that could engage in productive activity and reap the rewards of innovation.  

The plurality and rivalry of states in late medieval Europe helped create the conditions for the emergence of capitalism (Tilly 1975; Scott 2011). Water and mountains divided multiple lowland populations, making the continent difficult to unify politically (a feat now on the agenda but hitherto signaled by the Romans alone). This medieval political division had a number of important effects, particularly when merchant trade became well established from the eleventh century. The mobility of merchants and intellectuals within Europe, facilitated by some sharing of Latin, gave some the option to migrate to less-oppressive states (Weber 1968; Jones 1981; Pipes 1999). This created some pressure on relatively enlightened states to develop policies to encourage merchants and trade.

Once a merchant class became well established in a nation, it became a political lobby to defend its interests, reinforce countervailing power, and enable the development of a relatively autonomous system of law. In countries where merchants had greater power and autonomy (contrast England with Spain), the rewards of global trade made this class even more powerful and led to institutional changes that further checked the arbitrary power of the state. Access to emerging Atlantic trade routes enhanced this process of positive feedback between commerce and countervailing power (Cipolla 1965; Braudel 1984; Acemoglu, Johnson, and Robinson 2005a, 2005b; Acemoglu and Robinson 2012). To be effective, these changed institutions also had to bestow a degree of political stability within a complex system with divergent interests (Moore 1966).

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12. Berman (1983) showed that religion played an important role in the development of medieval legal systems. Since Weber (1904–5/1930), the idea that Protestantism played a positive role in capitalist development has become the subject of endless controversy. Andrew Tylecote has suggested to me in conversation that Weber may have been partly right for the wrong reasons. Protestantism did more than Catholicism to promote literacy and an ethic of equal access to scriptural knowledge and other entitlements, thus aiding technical and legislative progress. But this issue is beyond the scope of the present work.

13. Galbraith (1952, 1969) promoted the concept of “countervailing power” but referred specifically to the role of trade unions as a counterbalance to large corporations. North, Wallis, and Weingast (2009) referred more broadly to any organized power to check state tyranny. The earliest use of the term I have found is in a pamphlet by a stockholder that criticizes the lack of “countervailing power” within the governance structures of the East India College in Hertfordshire in England, where Malthus was a professor (Address to the Proprietors 1823).
Where they emerged, countervailing power within pluralist constella-
tions of institutions created spaces for the intelligensia, the Enlighten-
ment, and the advancement of science (Mokyr 2003, 2010). They also en-
couraged financial investment on a larger scale.

War between rival states periodically devastated Europe and often
checked its development. But in some cases—particularly in the island of
Britain—production of material for military and naval use itself gave a
Wars in the eighteenth century and the early nineteenth prompted the
development of more efficient state administrations and reductions in
public corruption (Neild 2001). The further development in the nin-
teenth century of the legal form of the corporation, the banking system,
and other institutions provided additional incentives and possibilities for
investment, innovation, and technical change.

Two important points emerge from this very brief summary of the
emergence of capitalism. First, the roles of the state and trade have been
vital. Second—and against both Marx and Schumpeter—the evolution of
national capitalist systems cannot be understood as a process that is ex-
clusively “from within.” As in the biological world, evolution depends on
the environment and rivalry with others as well as on the development of
the organism itself.

The Structure and Outline of This Book

Much of this book addresses the definitions of key terms such as law,
property, exchange, markets, money, capital, and capitalism. If it is at
least partly successful in this respect alone, then this is no meager
achievement. It means that the reader can delve selectively and un-
sequentially into chapters 3–10 in search of arguments for particular def-
initions.

But in addition there are some guiding threads that connect the chap-
ters together, and the less casual reader may be interested in these. One
of these is the general role of the state and law in constituting and sus-
taining capitalism. Another is the inevitability of missing markets in a
system that is nevertheless dominated by commodity exchange. A third
is the way that physicalist metaphors and a focus on associated agent-
object relations together corrode our definitions and understandings of
the system and its key components.

The first part of the book is entitled “Discovering Capitalism.” The
guiding narrative is toward the goal of a definition of capitalism in chap-
ter 10. Preceding chapters have a connected, logical sequence. Hence,
to understand capitalism we need to understand capital, to understand
capital we need to understand money, to understand money we need to
understand exchange, to understand exchange we need to understand
property, and to understand property we need to understand law. There
is also a chapter on firms and another on employment because these too
may plausibly enter the definition of capitalism.

The opening two chapters are important preliminaries to this logi-
cal sequence. Chapter 1 considers the definitional problem of identi-
fying key essential features of a class of phenomena of the same type.
Pinpointing the essence of multiple capitalist social formations means
identifying fundamental properties that make capitalism what it is, not-
withstanding important variations between different national capital-
isms. This chapter is the most philosophical, and some readers may be
inclined to skip it. But I suggest that they read section 1.3 and definitely
look at figure 1.1 on page 36. They are vital for what follows.

The next nine chapters are in descending levels of abstraction and ris-
ing degrees of historical specificity. Chapter 2 addresses issues of social
structure and individual motivation that have been relevant for human
societies at least since the development of a sophisticated language, very
roughly 100,000 years ago (Oppenheimer 2004). It stresses dispositions
such as conformism and obedience to authority that evolved in human
societies long before the dawn of civilization.

Chapter 3 considers the constitutive role of law in modern society.
Law is distinguished from custom. Law emerged in states with institu-
tionalized judiciaries, as first found in antiquity. Chapter 4 continues on
legal themes and insists on a difference between possession and prop-
erty, where the latter involves legal rights and obligations. It also empha-
sizes a definition of exchange entailing property rights rather than social
interaction alone.

Chapter 5 addresses the nature and definition of the market. Follow-

ing common parlance, it defines a market as an organized forum of ex-

change rather than trade in general. Markets in this sense are relatively
recent. A hitherto uncharted text suggests that they may have ex-
isted ca. 3000 BC in China, but there is no other known record of them
until the sixth century BC.

Chapter 6 considers money and compares spontaneous and state-
centered (or chartalist) views. It argues that money is essentially neither spontaneous nor entirely a creation of the state but that legal enforcements are vital for its existence. The chapter goes on to consider the evolution of more complex financial systems that first emerged in Italy, the Netherlands, and Great Britain. Chapter 7 considers the problematic word *capital* and how economists since Adam Smith progressively changed its meaning and ended up losing sight of core characteristics that are vital to understand *capital-*ism.

Chapter 8 considers firms and corporations, arguing that legal insights must be reintroduced in order to understand these institutions. Chapter 9 addresses the labor process and the employment relationship and weighs up their importance for the capitalist system. Chapter 10 finally reaches the point where the definition of capitalism is addressed. Capitalism is defined therein as a socioeconomic system with the following six characteristics:

1. A legal system supporting widespread individual rights and liberties to own, buy, and sell private property
2. Widespread commodity exchange and markets involving money
3. Widespread private ownership of the means of production by firms producing goods or services for sale in the pursuit of profit
4. Much of production organized separately and apart from the home and family
5. Widespread wage labor and employment contracts
6. A developed financial system with banking institutions, the widespread use of credit with property as collateral, and the selling of debt

There are two optional, five-point variant definitions, namely, *S*-capitalism (in honor of Schumpeter), which omits point (5) concerning employment, and *M*-capitalism (in honor of Marx), which omits point (6) concerning finance, credit, collateral, and the selling of debt. The case is made in the book for adopting all six points, but, as with all definitions, there is no supreme court that can offer a final verdict on the six-point definition's alleged superiority. The merits and demerits of different definitions have to be debated.

The second part of this book contains six further chapters and is entitled "Capitalism and Beyond." This addresses some key questions that are now subjects of popular interest, particularly after the Great Crash of 2008. These include the generic limitations of capitalism, its possible development in the twenty-first century, the effects of ongoing globalization, the possibility of a new global economic leader to overtake the United States, the problem of inequality and its causes, and the possibility of postcapitalist developments such as socialism.

To understand possibilities beyond capitalism we must appreciate how any system organizes and interacts with the processes of production. Chapter 11 considers the general nature, or ontology, of the production process. While this question is not specific to capitalism, it is vital to understand its nature and any postcapitalist possibilities. This is an important preliminary to the following chapter, which is on the viability of socialism.

Chapter 12 argues that the abolition of private property and its replacement by comprehensive planning—which until about 1950 was the meaning of socialism held by almost all its adherents—is incompatible with efficient, large-scale production in a modern, complex economy under a democratic polity. In this respect I give qualified support to the Austrian school in the great "socialist calculation debate" of the 1930s and 1940s. But, on the other hand, the state has a greater role to play in a viable and dynamic capitalist system than many critics of socialism envisage. Furthermore, the Austrian school defense of capitalism was gravely weakened by its poor definitions of property, exchange, and markets.

The final four chapters consider how capitalism evolves, its prospects, and other possible postcapitalist directions. Chapter 13 considers the mechanisms of capitalist evolution using insights from recent work on evolutionary theory. Chapter 14 further considers tendencies of capitalist development and argues that, despite globalization, capitalism will not converge on a single type. This opens up a choice between different varieties of capitalism, including between different levels of economic inequality. Capitalism engenders equal commercial rights under the law but has generated greater inequalities in the distribution of income and wealth. Chapter 15 addresses the sources of this inequality and briefly considers some possible policy remedies. Chapter 16 considers further reforms of capitalist institutions and offers glimpses of possible routes beyond capitalism.
ers. Markets and private ownership would still exist. But there would no longer be an employment relation. Is a system with self-employed commodity producers fundamentally different from a private enterprise economy in which most workers are employed? Some characteristics would be very different. A community of self-employed commodity producers would face the extended transaction costs of exchanging their commodity outputs with one another, and this would limit technological possibilities as well as affecting the organization and character of the production process. Working for oneself is very different from working for a boss.

Consider a second scenario where all firms are transformed into worker cooperatives. The workers would own all the shares in their own enterprises. Their outputs would be sold collectively, creating revenue for the cooperative as a whole. Such a system could allow large-scale production and cooperation, but its inner dynamic, the character of industrial relations, and the motivations of the workers could differ radically from a system that relied instead on contracts of employment. This could remain true even if there were a financial sector run along capitalist lines on which many cooperatives depended for their finance.

The points outlined above underline the distinctive importance of the employment relationship, even if its development does not closely match the spectacular rise of capitalism from the eighteenth century. Hence, there are grounds for considering the employment relationship as an essential feature of capitalism even if it is relatively unhelpful in providing a criterion to identify and date the rise of that system. The inclusion of this criterion will be considered further in the following chapter, where I bring the important definitional characteristics together.

8. In his supplement to vol. 3 of Marx's Capital, Engels introduced the term simple commodity production to describe such an arrangement, suggesting that it had preceded capitalism historically (Marx 1981, 1037). But apparently Marx never used the terms simple or petty commodity production.


CHAPTER TEN

A Definition of Capitalism

At the very roots of the capitalist mode of production, [is] the self-valorization of capital... by means of the "free" purchase and consumption of labour-power. — Karl Marx (1867)

"Credit" operations... affect the capitalist engine—so much so as to become an essential part of it without which it cannot be understood at all. — Joseph A. Schumpeter (1954)

Capitalism is better viewed as a "historical formation," distinguished from formations that have preceded it... both by a core of central institutions and by the motion these institutions impart to the whole. Although capitalism assumes a wide variety of appearances from period to period and place to place... these core institutions and distinctive movements are discoverable in all of them, and allow us to speak of capitalism as a historical entity. — Robert L. Heilbroner (1987)

This chapter brings together several threads from earlier chapters and attempts to define capitalism. The origins of the word are explored. Many dictionary definitions focus on private property and markets, but—in line with both Karl Marx and Joseph Schumpeter—it is argued that such definitions are too broad and unspecific.

The second section considers the notion of "state capitalism." It is argued that the term state capitalism might usefully be applied to state-dominated varieties of capitalism that also involve private property, exchange, and a developed financial sector but that it does not usefully apply to Soviet-style systems that lack extensive private ownership of the means of production, widespread commodity markets, and financial markets. The third section proposes a six-condition definition of capitalism with two optional variants.
10.1. Capitalism and Its Usage

According to Fernand Braudel (1982, 234): “The word capitalist probably dates from the seventeenth century.” It was taken to mean an owner of much money or wealth. In French, A. R. J. Turgot used capitale in his 1774 “Reflections on the Formation and Distribution of Wealth.” William Godwin used the word capitalist in his Enquiry concerning Political Justice (1793). David Ricardo used it several times in his Principles of 1817.

The person most widely credited with the invention of the word capitalism is the socialist Louis Blanc in his Organisation du travail. Absent from at least the first five editions (from 1839 to 1848), it appears in the ninth, where Blanc (1850, 161) wrote of the “fallacy” of the “usefulness of capital” being “perpetually confused with what I call capitalism, that is to say the appropriation of capital by some, to the exclusion of others.” In 1849 the word capitalism appeared in an English translation of an article by Blanc, written while he was in exile in London. Blanc (1849, 117) wrote: “The suppression of capitalism cannot, then, have anything to do with the suppression of capital.”

Shortly afterward, Pierre-Joseph Proudhon (1851, 271) used the term capitalism, and its usage slowly widened in both English and French. William Makepeace Thackeray wrote of “capitalism” in his 1855 novel The Newcomes. Karl Marx wrote frequently of the “capitalist mode of production” and of “capitalists.” But he rarely used the term capitalism. It appears only twice in the first volume of Capital (1867) and nine times in the following two volumes. Its frequency in German was boosted greatly by the publication of Kapitalismus und Sozialismus by the non-socialist, historical school economist Albert Schäffle in 1879.

Having dealt with the origins of the word, we now turn to its current meanings. Definitions proliferate. Most dictionaries stress private ownership and markets; many add the profit motive. The entry in The New Encyclopaedia Britannica (1998, 2:831) is typical: “Capitalism, also called free market economy, or free enterprise economy: economic system ... in which most of the means of production are privately owned and production is guided and income distributed largely through the operation of markets.”

But, if we consider systems based largely on private ownership, the profit motive, and markets, we can find many examples before the medieval era. As noted in previous chapters, trade has existed for tens of thousands of years, markets may have appeared as long as five millennia ago in China, and they were evident in several locations in the eastern Mediterranean and the Middle East around 600 BC. Private ownership, the pecuniary calculus, and the profit motive have similarly played a prominent role in leading economic regions for thousands of years. Hence, prominent dictionary definitions of capitalism make it a system that has lasted for multiple millennia. If we adopt such definitions, then we need to find another word to describe the institutional structures that were consolidated in the eighteenth century and gave rise to spectacular economic growth and ongoing technological innovation.

Marx took a different approach. While he emphasized the roles of private property, markets, and profit, he also highlighted wage labor and the employment relationship. Marx (1976, 291–92) saw wage labor as a defining feature of the capitalist mode of production. More fully, Marx (1881, 1019–20) wrote:

Two characteristic traits mark the capitalist mode of production right from the start. Firstly, it produces its products as commodities. The fact that it produces commodities does not in itself distinguish it from other modes of production; but that the dominant and determining character of its product is the

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1. “Ce sophisme consiste à confondre perpétuellement l'utilité du capital avec ce que j'appellerai le capitalisme, c'est-à-dire l'appropriation du capital par les uns, à l'exclusion des autres.”

2. It is unclear whether this is the first appearance of capitalism or capitalism or whether it is preceded in an undiscovered 1848 or 1849 edition of Organisation du travail.


4. Hobson (1926, 1) also made employment central to his definition: “Capitalism may provisionally be defined as the organization of business upon a large scale by an employer or company of employers possessing an accumulated stock of wealth wherewith to acquire raw materials and tools, and hire labour, so as to produce an increased quantity of wealth which shall constitute growth.”
commodity certainly does so. This means, first of all, that...labour generally appears as wage-labour...[and] the relationship of capital to wage-labour determines the whole character of the mode of production...The second thing that particularly marks the capitalist mode of production is the production of surplus-value as the direct object and decisive motive of production.

When describing the capitalist mode of production, Marx emphasized private property, widespread commodification, and markets, including the hiring of labor power and wage labor (Khalil 1992). Hence, the Marxist writer Ernest Mandel (1967) described capitalism as "generalized commodity production." Marx and Mandel made it clear that labor power and money were also commodities. With a slight modification of Marx's position, the term *M-capitalism* is used here to refer to a definition of capitalism in terms of the following five characteristics:

1. A legal system supporting widespread individual rights and liberties to own, buy, and sell private property
2. Widespread commodity exchange and markets involving money
3. Widespread private ownership of the means of production by firms producing goods or services for sale in the pursuit of profit
4. Much of production organized separately and apart from the home and family
5. Widespread wage labor and employment contracts

Most dictionary and encyclopedia definitions emphasize conditions (1), (2), and (3), albeit often without emphasis on the legal system. More than Marx, the notion of M-capitalism emphasizes the legal system and individual rights.5 Regarding condition (4), the separation of much production from the family and the domestic sphere was emphasized by Weber (1968) and is implicit in Marx's writings. Weber rightly argued that this separation was important to subject production to systems of rational accounting and pecuniary motivation. Marx emphasized condition (5) because it flows from the nature of capitalism as generalized commodity production and encapsulates the driving antagonism between the employing class and the working class. With this awesome concep-

5. Marx's account of capitalism emphasized money (condition [2]), but he laid no stress on collateralization, credit money, or the selling of debt (see condition [6] in the definition of S-capitalism below).

A definition of capitalism, Marx linked the free market, possessive individualism of the classical liberal era with the class struggle and the promise of its transformation into collective property under proletarian rule.

A problem, as noted in the previous chapter, is that the addition of condition (5), widespread wage labor, to the preceding four does not effectively demarcate modern industrial capitalism from the four preceding centuries when wage labor was widespread in rural England. M-capitalism, as specified above, gives us a better-than-average definition, but not one that is sufficiently sharp in terms of historical specificity.

Further problems of historical demarcation arise with the first four conditions. As noted in section 4.4 above, the idea that secure property rights were first established in England in the seventeenth century is a myth. Furthermore, money, markets, and private ownership have existed for millennia. The fourth condition is helpful but hardly sufficient as an explanation of massive expansion of capitalism around 1800. The five conditions are inadequate to demarcate historically the explosion of capitalist productivity even if they are necessary for that system.

In search of help we turn to Joseph A. Schumpeter, who emphasized the development of financial institutions. Schumpeter (1934, 126) saw the money markets as the "headquarters" of capitalism. Schumpeter (1939, 223) wrote: "Capitalism is that form of private property economy in which innovations are carried out by means of borrowed money, which in general...implies credit creation." Schumpeter (1954, 78) also thought that "the development of the law and the practice of negotiable paper and of 'created' deposits afford perhaps the best indication we have for dating the rise of capitalism." For him, the "capitalist engine" could not be understood without reference to its credit operations and a distinctive monetary system, involving the creation of money by banks through the selling of debt (Schumpeter 1954, 318–20). This inspires a definition of S-capitalism; it involves the following:

1. A legal system supporting widespread individual rights and liberties to own, buy, and sell private property
2. Widespread commodity exchange and markets involving money

6. But note that, while he emphasized the role of the financial sector, Schumpeter made little of the distinction between property and possession and the role of collateralization. As with Marx and M-capitalism, we are crediting Schumpeter with slightly more than his due.
3. Widespread private ownership of the means of production by firms producing goods or services for sale in the pursuit of profit
4. Much of production organized separately and apart from the home and family.
5. [No condition specified]
6. A developed financial system with banking institutions, the widespread use of credit with property as collateral, and the selling of debt

The addition of condition (6) takes seriously the monetary definition of capital and institutions promoting collateralization and the salability of debt. Capitalism is thus marked by “the predominance of ‘capital’” (Sombart 1930, 196). This definition points to the development of institutions of clearer historical specificity. According to this definition, the emergence of capitalism in England is marked by developments in financial institutions in the eighteenth century.

Note that condition (1) in the definitions of M-capitalism and S-capitalism rules out (at least widespread) slavery. Consequently, both M-capitalism and S-capitalism involve missing futures markets for labor. With S-capitalism, there may be self-employment or worker cooperatives but not extensive slave labor. M-capitalism rules out an economy with predominant self-employment or worker cooperatives.

But there is a cost to the exclusion of condition (5) from this definition. As argued in the preceding chapter, the advantage of retaining the employment contract in the definition of capitalism is that it demarcates the system from economies involving self-employed producers or worker cooperatives. Furthermore, the introduction of wage labor gave important incentives for labor-saving innovations and led to increases in productivity. Consequently, the definition of capitalism that is favored here—and described simply as capitalism, without any prefix—involves all six of the above conditions.

7. Note the money-based definition of capital developed in chapter 7 above. Both Sombart (1902, 1930) and Weber (1904–5/1930, 1968) defined capitalism partly in terms of its rational, pecuniary, and entrepreneurial Geist, “spirit” or “economic outlook.” But Commons criticized Weber and Sombart for giving ideas and spirit—instead of property and other relations—too much weight. Commons (1934, 732–34) noted their “failure to start economic theory upon the economic bond which ties individuals together, such as transactions, debts, property rights.” For Commons, ideas were important, but social and legal relations were also fundamental. See Hodgson (2001) for further criticisms of the concept of Geist.

Nevertheless, as with all definitions, there is no finality. That may exasperate the lover of mathematical proofs. But mathematics and reality are different worlds. The beautiful finalities of the former are not found in analytic engagements with the latter. The virtues of different definitions of capitalism are a matter for ongoing debate.

10.2. State Capitalism?

From the late nineteenth century, some Marxist writers (including V. I. Lenin and Wilhelm Liebknecht) and non-Marxist writers proposed that state ownership and management of a large part of a market economy would amount to state capitalism. But subsequently the term was applied to planned economies. By the 1940s some Marxists (such as Amadeo Bordiga and Raya Dunayevskaya) were describing the Soviet Union as state capitalist.

Accordingly, Tony Cliff (1955), Ernesto Screepanti (1997, 2001), and others proposed that private ownership is not a defining feature of capitalism; instead, it is control by a minority of the labor process, as in the employment contract. Unimpeded by any definitional reference to private ownership of the means of production or to the existence of money capital or capital markets, all twentieth-century systems, from the market-driven West to planned systems under Stalin and Mao, were described as capitalist.

8. Ultranationalistic, describing all modern and some other social formations as capitalist, conveniently blacken everything. It removes the need to identify any positive features of any system. By contrast, those who approvingly describe the former Soviet Union, Mao’s China, or North Korea as socialist are obliged either to ignore the famines, prison camps, mass executions, and purges or to perform acrobatic acts of apology. Trotsky’s (1929) description of these regimes as “transitional” and “degenerated workers’ states” is also unsatisfactory, partly because the workers never controlled the state. A fourth option for a Marxist is to describe these systems as bureaucratic collectivist (or similar) with a “new class” in control (Shachtman 1940). These dilemmas can be avoided by ditching the Marxist notion that systems are defined by a class in power. Instead, systems can be defined by the social and legal relations that dominate and regulate the production and distribution of their wealth. State planned economy is a possible label for a Soviet-type system. But non-Marxists on the Left still have the problem that the word socialism has been historically associated with central planning, as found in the aforementioned totalitarian regimes. Perhaps the Left has to abandon the term socialism as well, possibly in favor of social democracy (with its post-1959 and Bad Godesberg meaning).
There are arguments against this preeminent definitional emphasis on control. First, owners have significant legal and real powers over the managers even if these powers are not exercised daily. The separation of ownership from control in modern capitalism (Berle and Means 1932) does not imply that ownership is unimportant or does not carry with it significant powers. Second, ownership of the means of production is a means of obtaining property income even if direct control of the labor process is not exercised. Third, the employment contract itself always involves some form of (public or private) ownership of the means of production and in particular the private ownership of labor power itself. Fourth, the employment contract does not involve absolute control and typically is accompanied by a significant zone of autonomy and discretion for the workers (Littler and Salaman 1982; Nelson 1981b).

More generally, the argument for retaining notions of property in the definition of capitalism is that property and contract are key elements of the modern system of production and distribution. Removing these and other legal terms from the definition would fail to identify major features of the modern social order, including the roles played by commodity exchange, financial markets, and the collateralization of private property.

As well as recognizing that significant power does emanate from ownership, one of the advantages of retaining both private ownership of the means of production and the existence of an employment relationship in the definition of capitalism is that such a denotation differentiates the former Eastern Bloc countries from capitalism. This conceptual differentiation underlines the major structural and ideological contrasts between East and West that dominated the world scene from 1917 to 1989. After 1989 these economies faced the huge tasks of building markets and capitalist financial institutions. The switch of their economic “headquarters” from their central planning bureaus to their financial markets involved massive institutional changes of enormous significance. The understanding of capital as money, depending on a web of legal and financial institutions, means that neither the Soviet Union nor Maoist China was capitalist. Capitalism is still reasonably defined in terms of private ownership of the means of production, the ubiquity of the employment relationship, and the dominance of financial institutions.

Following Lenin and Liebknecht, a better use of the term state capitalism is to describe state-dominated versions of capitalism as that system is defined here. This might include the reformed Chinese system, which since 1978 has involved a combination of markets, private and state enterprise, with state management and coordination of much of the economy (Naughton 2007; Huang 2008; Bremmer 2010; Coase and Wang 2012; Hodgson and Huang 2013; Peck and Zhang 2013; Wu 2013). Hence, there is a case for describing post-1980 China as state capitalist.

But the large financial sector in China is restrictive and structurally inflexible. Banking in China is largely dominated by the state, and favorable access to the state bureaucracy is often a condition for obtaining capital for business investment (Boyreau-Debray and Wei 2005). The Chinese legal system is also underdeveloped by Western standards. China is clearly a socioeconomic system in transition. The classical institutions of capitalism are incompletely developed. Once again, it is a question of drawing the line and determining on what side of it China should sit. I leave this issue open for future debate.

### 10.3. In Summary: Defining Capitalism

For the reasons given above, capitalism is defined here as a system of production with the following six characteristics:

1. A legal system supporting widespread individual rights and liberties to own, buy, and sell private property
2. Widespread commodity exchange and markets involving money
3. Widespread private ownership of the means of production by firms producing goods or services for sale in the pursuit of profit
4. Much of production organized separately and apart from the home and family
5. Widespread wage labor and employment contracts
6. A developed financial system with banking institutions, the widespread use of credit with property as collateral, and the selling of debt

This six-condition definition is given two further variants. M-capitalism (broadly after Marx) is a social system defined by conditions (1), (2), (3), (4), and (5). S-capitalism (after Schumpeter) is a social system defined by conditions (1), (2), (3), (4), and (6). To adapt a lapsed advertising slogan from a famous British retail company, capitalism is “not just” markets and private property but M&S-capitalism—or capitalism for short. Conditions (5) and (6) serve as fuzzy historical bookends, together demarcating capitalism from preceding systems and possible successors.
As noted in chapter 1 above, a definition is neither an analysis nor an adequate description. All sorts of vital things are missing from the six-point definition. For example, capitalism involves human beings that must eat to survive. While human nutrition is needed for capitalism to survive, it is not part of the essence because it does not demarcate this system from others. Similarly, the definition of capitalism does not have to point out that a social system depends on shared meanings, culture, habits, or whatever. Likewise, there are all sorts of complex and analytic issues—such as the nature of property or money and the sources of its dynamism—that do not have to enter into the definition of capitalism because they are defined or analyzed elsewhere.

For example, why is technological innovation absent from the definition? Again, things that are vital to the system do not necessarily have to be included in a definition. If we listed everything that was important, then a definition would be many pages long. A definition of a system is different from an analysis of how a system works. Definitions are about demarcation, not analysis. Arguably, technological innovation is a possible behavioral consequence of the core capitalist institutions, and some forms of capitalism have been relatively stagnant technologically.

As another example, why is the organization and diffusion of knowledge absent from the definition of capitalism? Again, the organization and diffusion of knowledge are clearly vital for this system. But they play a fundamental role in any economy involving communication and cooperation between agents. Hence, the organization and diffusion of knowledge does not demarcate capitalism from other systems, and, hence, it is not part of its definition.

Explicit reference to social class is also absent from the definition offered above. In his review of different definitions of capitalism, Michael Merrill (1995) argued that capitalism is much more than simply a market economy. He was right about that. But he wanted to define capitalism as "a market economy ruled by, or in the interests of, capitalists" (322). A problem, as noted in chapter 2 above, is that the basis of class itself has to be defined, and Marx and Engels were obliged to use legal terms such as ownership to do so. Being a capitalist or a worker is not a congenital attribute: it is the occupation of a social role that is determined in part by legal relations. Class-related legal terms appear in all points above, except condition (4).

Marxists have abused class-centered definitions of capitalism. They see class struggle, where the destiny of one class is to seize control of the
Joseph Schumpeter, a great economist and social scientist of the last generation, whose career was almost equally divided between Central European and American universities, and who lived close to the crises of the 1930s and '40s, published a book in 1942 under the title, Capitalism, Socialism, and Democracy. The book has had great influence, and can be read today with profit. It was written in the aftermath of the great depression, during the early triumphs of Fascism and Nazism in 1940 and 1941, when the future of capitalism, socialism, and democracy all were in doubt. Schumpeter projected a future of declining capitalism, and rising socialism. He thought that democracy under socialism might be no more impaired and problematic than it was under capitalism.

He wrote a concluding chapter in the second edition which appeared in 1946, and which took into account the political-economic situation at the end of the war, with the Soviet Union then astride a devastated Europe. In this last chapter he argues that we should not identify the future of socialism with that of the Soviet Union, that what we had observed and were observing in the first three decades of Soviet existence was not a necessary expression of socialism. There was a lot of Czarist Russia in the mix. If Schumpeter were writing today, I don't believe he would argue that socialism has a brighter future than capitalism. The relationship between the two has turned out to be a good deal more complex and intertwined than Schumpeter anticipated. But I am sure that he would still urge us to separate the future of socialism from that of Soviet and Eastern European Communism.

Unlike Schumpeter I do not include Socialism in my title, since its future as a distinct ideology and program of action is unclear at best. Western Marxism and the moderate socialist movements seem to have settled for social democratic solutions, for adaptations of both capitalism and democracy producing acceptable mixes of market competition, political pluralism, participation, and welfare. I deal with these modifications of capitalism, as a consequence of the impact of democracy on capitalism in the last half century.

At the time that Adam Smith wrote The Wealth of Nations, the world of government, politics and the state that he knew—pre-Reform Act England, the French government of Louis XV and XVI—was riddled with special privileges, monopolies, interferences with trade. With my tongue only half way in my cheek I believe the discipline of economics may have been traumatized by this condition of political life at its birth. Typically, economists speak of the state and government instrumentally, as a kind of secondary service mechanism.

I do not believe that politics can be treated in this purely instrumental and reductive way without losing our analytic grip on the social and historical process. The economy and the polity are the main problem solving mechanisms of human society. They each have their distinctive means, and they each have their "goods" or ends. They necessarily interact with each other, and transform each other in the process. Democracy in particular generates goals and programs. You cannot give people the suffrage, and let them form organizations, run for office, and the like, without their developing all kinds of ideas as to how to improve things. And sometimes some of these ideas are adopted, implemented and are productive, and improve our lives, although many economists are reluctant to concede this much to the state.

My lecture deals with this interaction of politics and economics in the Western World in the course of the last couple of centuries, in the era during which capitalism and democracy emerged as the dominant problem solving institutions of modern civilization. I am going to discuss some of the theoretical and empirical literature dealing with the themes of the positive and negative
interaction between capitalism and democracy. There are those who say that capitalism supports democracy, and those who say that capitalism subverts democracy. And there are those who say that democracy subverts capitalism, and those who say that it supports it.

The relation between capitalism and democracy dominates the political theory of the last two centuries. All the logically possible points of view are represented in a rich literature. It is this ambivalence and dialectic, this tension between the two major problem solving sectors of modern society—the political and the economic—that is the topic of my lecture.

Capitalism Supports Democracy

Let me begin with the argument that capitalism is positively linked with democracy, shares its values and culture, and facilitates its development. This case has been made in historical, logical, and statistical terms.

Albert Hirschman in his Rival Views of Market Society (1986) examines the values, manners and morals of capitalism, and their effects on the larger society and culture as these have been described by the philosophers of the 17th, 18th, and 19th centuries. He shows how the interpretation of the impact of capitalism has changed from the enlightenment view of Montesquieu, Condorcet, Adam Smith and others, who stressed the doceur of commerce, its “gentling,” civilizing effect on behavior and interpersonal relations, to that of the 19th and 20th century conservative and radical writers who described the culture of capitalism as crassly materialistic, destructively competitive, corrosive of morality, and hence self-destructive. This sharp almost 180-degree shift in point of view among political theorists is partly explained by the transformation from the commerce and small-scale industry of early capitalism, to the smoke blackened industrial districts, the demonic and exploitive entrepreneurs, and exploited laboring classes of the second half of the nineteenth century. Unfortunately for our purposes, Hirschman doesn’t deal explicitly with the capitalism–democracy connection, but rather with culture and with manners. His argument, however, implies an early positive connection and a later negative one.

Joseph Schumpeter in Capitalism, Socialism, and Democracy (1942) states flatly, “History clearly confirms . . . [that] . . . modern democracy rose along with capitalism, and in causal connection with it . . . modern democracy is a product of the capitalist process.” He has a whole chapter entitled “The Civilization of Capitalism,” democracy being a part of that civilization. Schumpeter also makes the point that democracy was historically sup-

The relation between capitalism and democracy dominates the political theory of the last two centuries.

to contain and dominate the rising commercial classes, produced an authoritarian and fascist version of industrial modernization, a system of capitalism encased in a feudal authoritarian framework, dominated by a military aristocracy, and an authoritarian monarchy. The third route, followed in Russia where the commercial bourgeoisie was too weak to give content and direction to the modernizing process, took the form of a revolutionary process drawing on the frustration and resources of the peasantry, and created a mobilized authoritarian Communist regime along with a state-controlled industrialized economy. Successful capitalism dominating and transforming the rural agricultural sector, according to Barrington Moore, is the creator and sustainer of the emerging democracies of the nineteenth century.

Robert A. Dahl, the leading American democratic theorist, in the new edition of his book (1990) After the Revolution? Authority in a Good Society, has included a new chapter entitled “Democracy and Markets.” In the opening paragraph of that chapter, he says:

It is an historical fact that modern democratic institutions . . . have existed only in countries with predominantly privately owned, market-oriented economies, or capitalism if you prefer that name. It is also a fact that all “socialist” countries with predominantly state-owned centrally directed economic orders—command economies—have not enjoyed democratic governments, but have in fact been ruled by authoritarian dictatorships. It is also an historical fact that some “capitalist” countries have also been, and are, ruled by authoritarian dictatorships.

To put it more formally, it looks to be the case that market-oriented economies are necessary (in the logical sense) to democratic institutions, though they are certainly not sufficient. And it looks to be the case that state-owned centrally directed economic orders are strictly associated with authoritarian regimes, though authoritarianism definitely does not require them. We have something very much like an historical experiment, so it would appear, that leaves these conclusions in no great doubt. (Dahl 1990)

Peter Berger in his book The
Capitalism and Democracy

Capitalist Revolution (1986) presents four propositions on the relations between capitalism and democracy:

- Capitalism is a necessary but not sufficient condition of democracy under modern conditions.
- If a capitalist economy is subjected to increasing degrees of state control, a point (not precisely specifiable at this time) will be reached at which democratic governance becomes impossible.
- If a socialist economy is opened up to increasing degrees of market forces, a point (not precisely specifiable at this time) will be reached at which democratic governance becomes a possibility.
- If capitalist development is successful in generating economic growth from which a sizable proportion of the population benefits, pressures toward democracy are likely to appear.

This positive relationship between capitalism and democracy has also been sustained by statistical studies. The “Social Mobilization” theorists of the 1950s and 1960s which included Daniel Lerner (1958), Karl Deutsch (1961), S. M. Lipset (1959) among others, demonstrated a strong statistical association between GNP per capita and democratic political institutions. This is more than simple statistical association. There is a logic in the relation between level of economic development and democratic institutions. Level of economic development has been shown to be associated with education and literacy, exposure to mass media, and democratic psychological propensities such as subjective efficacy, participatory aspirations and skills. In a major investigation of the social psychology of industrialization and modernization, a research team led by the sociologist Alex Inkeles (1974) interviewed several thousand workers in the modern industrial and the traditional economic sectors of six countries of differing culture. Inkeles found empathetic, efficacious, participatory and activist propensities much more frequently among the modern industrial workers, and to a much lesser extent in the traditional sector in each one of these countries regardless of cultural differences.

The historical, the logical, and the statistical evidence for this positive relation between capitalism and democracy is quite persuasive.

**Capitalism Subverts Democracy**

But the opposite case is also made, that capitalism subverts or undermines democracy. Already in John Stuart Mill (1848) we encounter a view of existing systems of private property as unjust, and of the free market as destructively competitive—aesthetically and morally repugnant. The case he was making was a normative rather than a political one. He wanted a less competitive society, ultimately socialist, which would still respect individuality. He advocated limitations on the inheritance of property and the improvement of the property system so that everyone shared in its benefits, the limitation of population growth, and the improvement of the quality of the labor force through the provision of high quality education for all by the state. On the eve of the emergence of the modern democratic capitalist order John Stuart Mill wanted to control the excesses of both the market economy and the majority polity, by the education of consumers and producers, citizens and politicians, in the interest of producing morally improved free market and democratic orders. But in contrast to Marx, he did not thoroughly discount the possibilities of improving the capitalist and democratic order.

Marx argued that as long as capitalism and private property existed there could be no genuine democracy, that democracy under capitalism was bourgeois democracy, which is to say not democracy at all. While it would be in the interest of the working classes to enter a coalition with the bourgeoisie in supporting this form of democracy in order to eliminate feudalism, this would be a tactical maneuver. Capitalist democracy could only result in the increasing exploitation of the working classes. Only the elimination of capitalism and private property could result in the emancipation of the working classes and the attainment of true democracy. Once socialism was attained the basic political problems of humanity would have been solved through the elimination of classes. Under socialism there would be no distinctive democratic organization, no need for institutions to resolve conflicts, since there would be no conflicts. There is not much democratic or political theory to be found in Marx’s writings. The basic reality is the mode of economic production and the consequent class structure from which other institutions follow.

For the followers of Marx up to the present day there continues to be a negative tension between capitalism, however reformed, and democracy. But the integral Marxist and Leninist rejection of the possibility of an autonomous, bourgeois democratic state has been left behind for most Western Marxists. In the thinking of Poulantzas, Offe, Bobbio, Habermas and others, the bourgeois democratic state is now viewed as a class struggle state, rather than an unambiguously bourgeois state. The working class has access to it; it can struggle for its interests, and can attain partial benefits from it. The state is now viewed as autonomous, or as relatively autonomous, and it can be reformed in a progressive direction by working class and other popular movements. The bourgeois democratic state can be moved in the direction of a socialist state by political action short of violence and institutional destruction.

Schumpeter (1942) appreciated the tension between capitalism and democracy. While he saw a causal connection between competition in the economic and the political order, he points out “...that there are some deviations from the principle of democracy which link up with the presence of organized capitalist interests....[T]he statement is true both from the standpoint of the classical and from the standpoint of our own theory of democracy. From the first
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standpoint, the result reads that the means at the disposal of private interests are often used in order to thwart the will of the people. From the second standpoint, the result reads that those private means are often used in order to interfere with the working of the mechanism of competitive leadership.” He refers to some countries and situations in which “. . . political life all but resolved itself into a struggle of pressure groups and in many cases practices that failed to conform to the spirit of the democratic method.” But he rejects the notion that there cannot be political democracy in a capitalist society. For Schumpeter full democracy in the sense of the informed participation of all adults in the selection of political leaders and consequently the making of public policy, was an impossibility because of the number and complexity of the issues confronting modern electorates. The democracy which was realistically possible was one in which people could choose among competing leaders, and consequently exercise some direction over political decisions. This kind of democracy was possible in a capitalist society, though some of its propensities impaired its performance. Writing in the early years of World War II, when the future of democracy and of capitalism were uncertain, he leaves unresolved the questions of “. . . Whether or not democracy is one of those products of capitalism which are to die out with it . . .” or “. . . how well or ill capitalist society qualifies for the task of working the democratic method it evolved.”

Non-Marxist political theorists have contributed to this questioning of the reconcilability of capitalism and democracy. Robert A. Dahl, who makes the point that capitalism historically has been a necessary precondition of democracy, views contemporary democracy in the United States as seriously compromised, impaired by the inequality in resources among the citizens. (1989) Dahl argues that the normative growth of democracy to what he calls its “third transformation” (the first being the direct city-state democracy of classic times, and the second, the indirect, representative egalitarian democracy of the contemporary world) will require democratization of the economic order. In other words, modern corporate capitalism needs to be transformed. Since government control and/or ownership of the economy would be destructive of the pluralism which is an essential requirement of democracy, his preferred solution to the problem of the mega-corporation is employee control of corporate industry. An economy so organized, according to Dahl, would improve the distribution of political resources without at the same time destroying the pluralism which democratic competition requires. To those who question the realism of Dahl’s solution to the problem of inequality, he replies that history is full of surprises.


We therefore come back to the corporation. It is possible that the rise of the corporation has offset more than offset the decline of class as an instrument of indoctrination. . . . That it creates a new core of wealth and power for a newly constructed upper class, as well as an overpowering loud voice, is also reasonably clear. The executive of the large corporation is, on many counts, the contemporary counterpart to the landed gentry of an earlier era, his voice amplified by the technology of mass communication. . . . [The major institutional barrier to fuller democracy may therefore be the autonomy of the private corporation.

Lindblom concludes, “The large private corporation fits oddly into democratic theory and vision. Indeed it does not fit.”

There is then a widely shared agreement, from the Marxists and neo-Marxists, to Schumpeter, Dahl, Lindblom, and other liberal political theorists, that modern capitalism with the dominance of the large corporation, produces a defective or an impaired form of democracy.

Democracy Subverts Capitalism

If we change our perspective now and look at the way democracy is said to affect capitalism, one of the dominant traditions of economics from Adam Smith until the present day stresses the importance for productivity and welfare of an economy that is relatively free of intervention by the state. In this doctrine of minimal government there is still a place for a framework of rules and services essential to the productive and efficient performance of the economy. In part the government has to protect the market from itself. Left to their own devices, according to Smith, businessmen were prone to corner the market in order to exact
the highest possible price. And according to Smith businessmen were prone to bribe public officials in order to gain special privileges, and legal monopolies. For Smith good capitalism was competitive capitalism, and good government provided just those goods and services which the market needed to flourish, could not itself provide, or would not provide. A good government according to Adam Smith was a minimal government, providing for the national defense, and domestic order. Particularly important for the economy were the rules pertaining to commercial life such as the regulation of weights and measures, setting and enforcing building standards, providing for the protection of persons and property, and the like.

For Milton Friedman (1961, 1981), the leading contemporary advocate of the free market and free government, and of the interdependence of the two, the principal threat to the survival of capitalism and democracy is the assumption of the responsibility for welfare on the part of the modern democratic state. He lays down a set of functions appropriate to government in the positive interplay between economy and polity, and then enumerates many of the ways in which the modern welfare, regulatory state has deviated from these criteria.

A good Friedmanesque, democratic government would be one "... which maintained law and order, defended property rights, served as a means whereby we could modify property rights and other rules of the economic game, adjudicated disputes about the interpretation of the rules, enforced contracts, promoted competition, provided a monetary framework, engaged in activities to counter technical monopolies and to overcome neighborhood effects widely regarded as sufficiently important to justify government intervention, and which supplemented private charity and the private family in protecting the irresponsible, whether madman or child. ...".

Against this list of proper activities for a free government, Friedman pinpointed more than a dozen activities of contemporary democratic governments which might better be performed through the private sector, or not at all. These included setting and maintaining price supports, tariffs, import and export quotas and controls, rents, interest rates, wage rates, and the like, regulating industries and banking, radio and television, licensing professions and occupations, providing social security and medical care programs, providing public housing, national parks, guaranteeing mortgages, and much else.

Friedman concludes that this steady encroachment on the private sector has been slowly but surely converting our free government and market system into a collective monster, compromising both freedom and productivity in the outcome. The tax and expenditure revolts and regulatory rebellions of the 1980s have temporarily stemmed this trend, but the threat continues. "It is the internal threat coming from men of good intentions and good will who wish to reform us. Impatient with the slowness of persuasion and example to achieve the great social changes they envision, they are anxious to use the power of the state to achieve their ends, and confident of their own ability to do so." The threat to political and economic freedom, according to Milton Friedman and others who argue the same position, arises out of democratic politics. It may only be defeated by political action.

In the last decades a school, or rather several schools, of economists and political scientists have turned the theoretical models of economics to use in analyzing political processes. Various called public choice theorists, rational choice theorists, or positive political theorists, and employing such models as market exchange and bargaining, rational self interest, game theory, and the like, these theorists have produced a substantial literature throwing new and often controversial light on democratic political phenomena such as elections, decisions of political party leaders, interest group behavior, legislative and committee decisions, bureaucratic, and judicial behavior, lobbying activity, and substantive public policy areas such as constitutional arrangements, health and environment policy, regulatory policy, national security and foreign policy, and the like. Hardly a field of politics and public policy has been left untouched by this inventive and productive group of scholars.

The institutions and names with which this movement is associated in the United States include Virginia State University, the University of Virginia, the George Mason University, the University of Rochester, the University of Chicago, the California Institute of Technology, the Carnegie Mellon University, among others. And the most prominent names are those of the leaders of the two principal schools: James Buchanan, the Nobel Laureate leader of the Virginia "Public Choice" school, and William Riker, the leader of the Rochester "Positive Theory" school. Other prominent scholars associated with this work are Gary Becker of the University of Chicago, Kenneth Shepsle and Morris Fiorina of Harvard, John Ferejohn of Stanford, Charles Plott of the California Institute of Technology, and many others.

One writer summarizing the ideological bent of much of this work, but by no means all of it (William Mitchell of the University of Washington), describes it as fiscally conservative, sharing a conviction that the "... private economy is far more robust, efficient, and perhaps, equitable than other economies, and much more successful than political processes in efficiently allocating resources. ..." Much of what has been produced "... by James Buchanan and the leaders of this school can best be described as contributions to a theory of the failure of political processes." These failures of political performance are said to...
be inherent properties of the democratic political process. "Inequity, inefficiency, and coercion are the most general results of democratic policy formation." In a democracy the demand for publicly provided services seems to be insatiable. It ultimately turns into a special interest, "rent seeking" society. Their remedies take the form of proposed constitutional limits on spending power and checks and balances to limit legislative majorities.

One of the most visible products of this pessimistic economic analysis of democratic politics is the book by Mancur Olson, The Rise and Decline of Nations (1982). He makes a strong argument for the negative democracy-capitalism connection. His thesis is that the behavior of individuals and firms in stable societies inevitably leads to the formation of dense networks of collusive, cartelistic, and lobbying organizations that make economies less efficient and dynamic and politics less governable. "The longer a society goes without an upheaval, the more powerful such organizations become and the more they slow down economic expansion. Societies in which these narrow interest groups have been destroyed, by war or revolution, for example, enjoy the greatest gains in growth." His prize cases are Britain on the one hand and Germany and Japan on the other.

The logic of the argument implies that countries that have had democratic freedom of organization without upheaval or invasion the longest will suffer the most from growth-repressing organizations and combinations. This helps explain why Great Britain, the major nation with the longest immunity from dictatorship, invasion, and revolution, has had in this century a lower rate of growth than other large, developed democracies. Britain has precisely the powerful network of special interest organization that the argument developed here would lead us to expect in a country with its record of military security and democratic stability. The number and power of its trade unions need no description. The venerability and power of its professional associations is also striking. . . . In short, with age British society has acquired so many strong organizations and collusions that it suffers from an institutional sclerosis that slows its adaptation to changing circumstances and technologies. (Olson 1982)

By contrast, post-World War II Germany and Japan started organizationally from scratch. The organizations that led them to defeat were all dissolved, and under the occupation inclusive organizations like the general trade union movement and general organizations of the industrial unions and commercial community were first formed. These inclusive organizations had more regard for the general national interest and exercised some discipline on the narrower interest organizations. And both countries in the post-war decades experienced "miracles" of economic growth under democratic conditions.

Olson has hopes that a public educated to the harmful consequences of special interests to economic growth, full employment, coherent government, equal opportunity, and social mobility will resist special interest behavior, and enact legislation imposing anti-trust, and anti-monopoly controls to mitigate and contain these threats.

Democracy Fosters Capitalism

My fourth theme, democracy as fostering and sustaining capitalism, is not as straightforward as the first three. Historically there can be little doubt that as the suffrage was extended in the last century, and as mass political parties developed, democratic development impinged significantly on capitalist institutions and practices. Since successful capitalism requires risk-taking entrepreneurs with access to investment capital, the democratic propensity for redistributive and regressive policy tends to reduce the incentives and the resources available for risk-taking and creativity. Thus it can be argued that propensities inevitably resulting from democratic politics, as Friedman, Olson and many others argue, tend to reduce productivity, and hence welfare.

But precisely the opposite argument can be made on the basis of the historical experience of literally all of the advanced capitalist democracies in existence. All of them without exception are now welfare states with some form and degree of social insurance, health and welfare nets, and regulatory frameworks designed to mitigate the harmful impacts and shortfalls of capitalism. Indeed, the welfare state is accepted all across the political spectrum. Controversy takes place around the edges. One might make the argument that had capitalism not been modified in this welfare direction, it is doubtful that it would have survived.

This history of the interplay between democracy and capitalism is clearly laid out in a major study involving European and American scholars, entitled The Development of Welfare States in Western Europe.
and America (Flora and Heidenheimer 1981). The book lays out the relationship between the development and spread of capitalist industry, democratization in the sense of an expanding suffrage and the emergence of trade unions and left-wing political parties, and the gradual introduction of the institutions and practices of the welfare state. The early adoption of the institutions of the welfare state in Bismarck Germany, Sweden, and Great Britain were all associated with the rise of trade unions and socialist parties in those countries. The decisions made by the upper and middle class leaders and political movements to introduce welfare measures such as accident, old age, and unemployment insurance, were strategic decisions. They were increasingly confronted by trade union movements with the capacity of bringing industrial production to a halt, and by political parties with growing parliamentary representation favoring fundamental modifications in, or the abolition of capitalism. As the calculations of the upper and middle class leaders led them to conclude that the costs of suppression exceeded the costs of concession, the various parts of the welfare state began to be put in place—accident, sickness, unemployment insurance, old age insurance, and the like. The problem of maintaining the loyalty of the working classes through two world wars resulted in additional concessions to working class demands: the filling out of the social security system, free public education to higher levels, family allowances, housing benefits, and the like.

Social conditions, historical factors, political processes and decisions produced different versions of the welfare state. In the United States, manhood suffrage came quite early, the later bargaining process emphasized free land and free education to the secondary level, an equality of opportunity version of the welfare state. The Disraeli bargain in Britain resulted in relatively early manhood suffrage and the full attainment of parliamentary government, while the Lloyd George bargain on the eve of World War I brought the beginnings of a welfare system to Britain. The Bismarck bargain in Germany produced an early welfare state, a post-

ponent of electoral equality and parliamentary government. While there were all of these differences in historical encounters with democratization and “welfarization,” the important outcome was that little more than a century after the process began all of the advanced capitalist democracies had similar versions of the welfare state, smaller in scale in the case of the United States and Japan, more substantial in Britain and the continental European countries.

We can consequently make out a strong case for the argument that democracy has been supportive of capitalism in this strategic sense. Without this welfare adaptation it is doubtful that capitalism would have survived, or rather, its survival, “unwelfarized,” would have required a substantial repressive apparatus. The choice then would seem to have been between democratic welfare capitalism, and repressive undemocratic capitalism. I am inclined to believe that capitalism as such thrives more with the democratic welfare adaptation than with the repressive one. It is in that sense that we can argue that there is a clear positive impact of democracy on capitalism.

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We have to recognize, in conclusion, that democracy and capitalism are both positively and negatively related, that they both support and subvert each other. My colleague, Moses Abramovitz, described this dialectic more surely than most in his presidential address to the American Economic Association in 1980, on the eve of the “Reagan Revolution.” Noting the decline in productivity in the American economy during the latter 1960s and ’70s, and recognizing that this decline might in part be attributable to the “tax, transfer, and regulatory” tendencies of the welfare state, he observes,

The rationale supporting the development of our mixed economy sees it as a pragmatic compromise between the competing virtues and defects of decentralized market capitalism and encompassing socialism. Its goal is to obtain a measure of distributive justice, security, and social guidance of economic life without losing too much of the allocative efficiency and dynamism of private enterprise and market organization. And it is a pragmatic compromise in another sense. It seeks to retain for most people that measure of personal protection from the state which private property and a private job market confer, while obtaining for the disadvantaged minority of people through the state that measure of support without which their lack of property or personal endowment would amount to a denial of individual freedom and capacity to function as full members of the community. (Abramovitz, 1981)

Democratic welfare capitalism produces that reconciliation of opposing and complementary elements which makes possible the survival, even enhancement of both of these sets of institutions. It is not a static accommodation, but rather one which fluctuates over time, with capitalism being compromised by the tax-transfer-regulatory action of the state at one point, and then correcting in the direction of the reduction of the intervention of the state at another point, and with a learning process over time that may reduce the amplitude of the curves.

The case for this resolution of the capitalism-democracy quandary is made quite movingly by Jacob Viner who is quoted in the concluding paragraph of Abramovitz’s paper, “...If...I nevertheless conclude that I believe that the welfare state, like old Siwash, is really worth fighting for and even dying for as compared to any rival system, it is because, despite its imperfection in theory and practice, in the aggregate it provides more promise of preserving and enlarging human freedoms, temporal prosperity, the extinction of mass misery, and the dignity of man and his moral improvement than any other social system which has previously prevailed, which prevails elsewhere today or which outside Utopia, the mind of man has been able to provide a blueprint for” (Abramovitz, 1981).

Note


September 1991
Building a Strong Legislature: The Western Experience*

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The Western democracies have gradually developed their legislative institutions over many centuries. Today the Soviet Union is building its own powerful legislature. Perhaps a look at the Western experience will be of interest to Soviet citizens who are currently thinking about how to make their own legislature an effective part of the democratic process.

Of course the Soviet Union is quite different from the Western democracies in many ways, including not only its political system, but also its economic system, its multinational character, and its social and cultural history, and the Western experience cannot be applied mechanically to such a different setting. But precisely because the Soviet Union is undertaking such bold experiments in restructuring, concrete experiences of others might be useful in suggesting ideas about legislative procedures, competitive elections, constituency relationships, and social norms.

Legislatures were originally developed in Britain, and later in France, because the kings constantly found themselves short of money.

As the power of royalty declined, the executive authority of the state was increasingly placed in a powerful bureaucracy led by executive officers who were responsible to the citizens. The relationship between the executive and the legislature has evolved in two quite different directions in the West. The most common method is the parliamentary system, whereby the executive is answerable to the legislature. The method used in the United States is the presidential system in which the leader of the executive branch of government is directly elected by the public independently of the elections for the legislature. A premise of Western democracy is that people are not angels. Therefore institutions should be structured so that when people respond to the incentives presented to them, the outcome will be acceptable. In writing the American Constitution, for example, the guiding principle was that ambition must be made to check ambition. Therefore, the Constitution implemented the doctrine of “checks and balances” to guarantee that no one part of the government would completely dominate the others. The president was given the right to veto proposed legislation, but the Congress was given the power to override the veto by a 2/3 vote in each chamber. Treaties and high-level presidential appointments require the approval of the Senate, and many actions of the Congress and the president are subject to review by the federal judiciary.

Since the American Congress is perhaps the most powerful legislature in the world, it is instructive to see just how it has built and maintained its autonomy. Congress began with the set of powers that have become the standard definition of legislative authority: the right to raise taxes, pass a budget, approve the key executive officers (except for the elected