

Capitalism

The evolution of capitalism

From mercantilism to commercial capitalism

It is usual to describe the earliest stages of capitalism as [mercantilism](#), the word denoting the central importance of the merchant overseas traders who rose to prominence in 17th- and 18th-century England, Germany, and the Low Countries. In numerous pamphlets, these merchants defended the principle that their trading activities buttressed the interest of the sovereign power, even when, to the consternation of the court, this required sending “treasure” (bullion) abroad. As the pamphleteers explained, treasure used in this way became itself a commodity in foreign trade, in which, as the 17th-century merchant [Thomas Mun](#) wrote, “we must ever observe this rule; to sell more to strangers than we consume of theirs in value.”

For all its trading mentality, mercantilism was only partially a market-coordinated system. [Adam Smith](#) complained bitterly about the government monopolies that granted exclusive trading rights to groups such as the [East India](#) or the Turkey companies, and modern commentators have emphasized the degree to which mercantilist economies relied on regulated, not free, prices and wages. The economic society that Smith described in [The Wealth of Nations](#) in 1776 is much closer to modern society, although it differs in many respects, as shall be seen. This 18th-century stage is called “commercial capitalism,” although it should be noted that the word capitalism itself does not actually appear in the pages of Smith's book.

Smith's society is nonetheless recognizable as capitalist precisely because of the prominence of those elements that had been absent in its mercantilist form. For example, with few exceptions, the production and distribution of all goods and services were entrusted to market forces rather than to the rules and regulations that had abounded a century earlier. The level of wages was likewise mainly determined by the interplay of the supply of, and the demand for, labour—not by the rulings of local magistrates. A company's earnings were exposed to [competition](#) rather than protected by government monopoly.

Perhaps of greater importance in perceiving Smith's world as capitalist as well as market-oriented is its clear division of society into an economic realm and a political realm. The [role of government](#) had been gradually narrowed until Smith could describe its duties as consisting of only three functions: (1) the provision of national defense, (2) the protection of each member of society from the injustice or oppression of any other, and (3) the erection and maintenance of those public works and public institutions (including education) that would not repay the expense of any private enterpriser, although they might “do much more than repay it” to society as a whole. And if the role of government in daily life had been delimited, that of commerce had been expanded. The accumulation of capital had come to be recognized as the driving engine of the system. The expansion of “capitals”—Smith's term for firms—was the determining power by which the market system was launched on its historic course.

Thus, *The Wealth of Nations* offered the first precise description of both the dynamics and the coordinative processes of capitalism. The latter were entrusted to the market mechanism—which

is to say, to the universal drive for material betterment, curbed and contained by the necessary condition of competition. Smith's great perception was that the combination of this drive and counterforce would direct productive activity toward those goods and services for which the public had the means and desire to pay while forcing producers to satisfy those wants at prices that yielded no more than normal profits. Later economists would devote a great deal of attention to the question of whether competition in fact adequately constrains the workings of the acquisitive drive and whether a market system might not display cycles and crises unmentioned in *The Wealth of Nations*. These were questions unknown to Smith, because the institutions that would produce them, above all the development of large-scale industry, lay in the future. Given these historical realities, one can only admire Smith's perception of the market as a means of solving the economic problem.

Smith also saw that the competitive search for capital accumulation would impart a distinctive tendency to a society that harnessed its motive force. He pointed out that the most obvious way for a manufacturer to gain wealth was to expand his enterprise by hiring additional workers. As firms expanded their individual [operations](#), manufacturers found that they could subdivide complex tasks into simpler ones and could then speed along these simpler tasks by providing their operatives with machinery. Thus, the expansion of firms made possible an ever-finer [division of labour](#), and the finer division of labour, in turn, improved profits by lowering the costs of production and thereby encouraging the further enlargement of the firms. In this way, the incentives of the market system gave rise to the augmentation of the wealth of the nation itself, endowing market society with its all-important historical momentum and at the same time making room for the upward striving of its members.

One final attribute of the emerging system must be noted. This is the tearing apart of the formerly seamless tapestry of social coordination. Under capitalism two realms of authority existed where there had formerly been only one—a realm of political governance for such purposes as war or law and order and a realm of economic governance over the processes of production and distribution. Each realm was largely shielded from the reach of the other. The capitalists who dominated the market system were not automatically entitled to governing power, and the members of government were not entrusted with decisions as to what goods should be produced or how social rewards should be distributed. This new dual structure brought with it two consequences of immense importance. The first was a limitation of political power that proved of very great importance in establishing democratic forms of government. The second, closer to the present theme, was the need for a new kind of analysis intended to clarify the workings of this new semi-independent realm within the larger social order. As a result, the emergence of capitalism gave rise to the discipline of economics.

From commercial to [industrial capitalism](#)

Commercial capitalism proved to be only transitional. The succeeding form would be distinguished by the pervasive [mechanization](#) and [industrialization](#) of its productive processes, changes that introduced new dynamic tendencies into the economic system while significantly transforming the social and physical landscape.

The transformative agency was already present in Smith's day, observable in a few coal mines where steam-driven engines invented by [Thomas Newcomen](#) pumped water out of the pits. The diffusion and penetration of such machinery-driven processes of production during the first quarter of the 19th century has been traditionally called “the” [Industrial Revolution](#), although historians today stress the long germination of the revolution and the many phases through which it passed. There is no doubt, however, that a remarkable confluence of advances in agriculture, cotton spinning and weaving, iron manufacture, and machine-tool design and the harnessing of mechanical power began to alter the character of capitalism profoundly in the last years of the 18th century and the first decades of the 19th.

The alterations did not affect the driving motive of the system or its reliance on market forces as its coordinative principles. Their effect was rather on the cultural complexion of the society that contained these new technologies and on the economic outcome of the processes of competition and capital accumulation. This aspect of industrialization was most immediately apparent in the advent of the [factory](#) as the archetypal locus of production. In Smith's time the individual enterprise was still small—the opening pages of *The Wealth of Nations* describe the effects of the division of labour in a 10-man pin factory—but by the early 19th century the increasing mechanization of labour, coupled with the application of [waterpower](#) and steam power, had raised the size of the workforce in an ordinary textile mill to several hundreds; by mid-century in the steel mills it was up to several thousands, and by the end of the century in the railways it was in the tens of thousands.

The increase in the scale of employment brought a marked change in the character of work itself. In Smith's day the social distance between employer and [labourer](#) was still sufficiently small that the very word manufacturer implied an occupation (a mechanic) as well as an ownership position. However, early in the 19th century [William Blake](#) referred to factories as “dark Satanic mills” in his epic poem *Jerusalem*, and by the 1830s a great gulf had opened between the manufacturers, who were now a propertied business class, and the men, women, and children who tended machinery and laboured in factories for 10- and 12-hour stints. It was from the spectacle of mill labour, described in unsparing detail by the inspectors authorized by the first [Factory Act](#) of 1802, that Marx drew much of the indignation that animated his analysis of capitalism. More important, it was from this same factory setting, and from the urban squalor that industrialization also brought, that capitalism derived much of the social consciousness—sometimes revolutionary, sometimes reformist—that was to play so large a part in its subsequent political life. Works such as Charles Dickens's *Hard Times* (1854) depicted the factory system's inhumanity and the underlying economic doctrines that supposedly justified it. While these works brought attention to the social problems stemming from industrialization, they also tended to discount the significant improvements in the overall standard of living (as measured by the increases in life expectancy and material comforts) that accompanied modernization. Country life of just a generation earlier had been no less cruel, and in some respects it was more inhuman than the factory system being criticized. Those critics who failed to compare the era of industrialization with the one that immediately preceded it also failed to account for the social and economic progress that had touched the lives of ordinary people.

The degradation of the physical and social landscape was the aspect of industrialization that first attracted attention, but it was its slower-acting impact on [economic growth](#) that was ultimately to

be judged its most significant effect. A single statistic may dramatize this process. Between 1788 and 1839 the output of [pig iron](#) in Britain rose from 68,000 to 1,347,000 tons. To fully grasp the significance of this 20-fold increase, one has to consider the proliferation of iron pumps, iron machine tools, iron pipes, iron rails, and iron beams that it made possible; these iron implements, in turn, contributed to faster and more dependable production systems. This was the means by which the [first Industrial Revolution](#) promoted economic growth, not immediately but with gathering momentum. Thirty years later this effect would be repeated with even more spectacular results when the Bessemer converter ushered in the age of steel rails, ships, machines, girders, wires, pipes, and containers.

The most important consequence of the industrialization of capitalism was therefore its powerful effect on enhancing what Marx called “the forces of production”—the source of what is now called the [standard of living](#). The Swiss economic demographer Paul Bairoch calculated that gross national product (GNP) per capita in the developed countries rose from \$180 in the 1750s (in dollars of 1960 purchasing power) to \$780 in the 1930s and then to \$3,000 in the 1980s, whereas the per capita income of the less-developed countries remained unchanged at about \$180–\$190 from 1750 to 1930 and thereafter rose only to \$410 in 1980. (This seemingly persistent gap between the richest and the poorest countries, which contradicts the predictions of the standard theory of economic growth, has increasingly occupied the attention of contemporary economists. Although the question is answered in part by explaining that the rich countries have experienced industrialization and the poor ones have not, the question remains why some have experienced industrialization and others have not.)

The development of industrialization was accompanied by periodic instability in the 18th and 19th centuries. Not surprisingly, then, one side effect of industrialization was the effort to minimize or prevent economic shocks by linking firms together into [cartels](#) or [trusts](#) or simply into giant integrated enterprises. Although these efforts dampened the repercussions of individual miscalculations, they were insufficient to guard against the effects of speculative panics or commercial convulsions. By the end of the 19th century, economic depressions had become a worrisome and recurrent problem, and the [Great Depression](#) of the 1930s rocked the entire capitalist world. During that debacle, GNP in the United States fell by almost 50 percent, business investment fell by 94 percent, and unemployment rose from 3.2 to nearly 25 percent of the civilian labour force. Economists have long debated the causes of the extraordinary increase in economic instability from 1830 to 1930. Some point to the impact of growth in the scale of production evidenced by the shift from small pin factories to giant enterprises. Others emphasize the role of miscalculations and mismatches in production. And still other explanations range from the inherent instability of capitalist production (particularly for large-scale enterprises) to the failure of government policy (especially with regard to the monetary system).

From industrial to state capitalism

The perceived problem of inherent instability takes on further importance insofar as it is a principal cause of the next structural phase of the system. The new phase is often described as state capitalism because its outstanding feature is the enlargement in size and functions of the

public realm. In 1929, for example, total [U.S.](#) government expenditures—federal, state, and local—came to less than one-tenth of GNP; from the 1970s they amounted to roughly one-third. This increase is observable in all major capitalist nations, many of which have reached considerably higher ratios of government disbursements to GNP than the United States.

At the same time, the function of [government](#) changed as decisively as its size. Already by the last quarter of the 19th century, the emergence of great industrial trusts had provoked legislation in the United States (although not in Europe) to curb the monopolistic tendencies of industrialization. Apart from these antitrust laws and the regulation of a few industries of special public concern, however, the functions of the federal government were not significantly broadened from Smith's vision. Prior to the Great Depression, for example, the great bulk of federal outlays went for defense and international relations, for general administrative expense and interest on the debt, and for the post office.

The Great Depression radically altered this limited view of government in the United States, as it had earlier begun to widen it in Europe. The provision of old-age pensions, relief for the hungry and poor, and a dole for the unemployed were all policies inaugurated by the administration of President Franklin D. Roosevelt, following the example of similar [enlargements of government](#) functions in Britain, France, and Germany. From the 1970s onward, such new kinds of federal spending—under the designation of social security, health, education, and welfare programs—grew to be 20 to 50 percent larger than the traditional categories of federal spending.

Thus, one very important element in the advent of a new stage of capitalism was the emergence of a large public sector expected to serve as a guarantor of public economic well-being, a function that would never have occurred to Smith. A second and equally important departure was the new assumption that governments themselves were responsible for the general course of economic conditions. This was a change of policy orientation that also emerged from the challenge of the Great Depression. Once regarded as a matter beyond remedy, the general level of national income came to be seen by the end of the 1930s as the responsibility of government, although the measures taken to improve conditions were on the whole timid, often wrongheaded (such as highly protectionist trade policies), and only modestly successful. Nonetheless, the appearance in that decade of a new economic accountability for government constitutes in itself sufficient reason to describe capitalism today in terms that distinguish it from its industrial, but largely unguided, past.

There is little doubt that capitalism will continue to undergo still further structural alterations. [Technological](#) advances are rapidly reducing to near insignificance the once-formidable barriers and opportunities of economic geography. Among the startling consequences of this technological leveling of the world have been the large displacements of high-tech manufacturing from Europe and North America to the low-wage regions of Southwest Asia, Latin America, and Africa. Another change has been the unprecedented growth of international finance to the point that, by the beginning of the 21st century, the total value of transactions in foreign exchange was estimated to be at least 20 times that of all foreign movements of goods and services. This boundary-blind internationalization of finance, combined with the boundary-defying ability of large corporations to locate their operations in low-wage countries, poses a

challenge to the traditional economic sovereignty of nations, a challenge arising from the new capabilities of capital itself.

A third change again involves the international economy, this time through the creation of new institutions for the management of international economic trade. A number of capitalist nations have met the challenges of the fast-growing international economy by joining the energies of the private sector (including organized labour) to the financial and negotiating powers of the state. This “corporatist” approach, most clearly evident in the organization of the Japanese economy, was viewed with great promise in the 1980s but in the 1990s was found to be severely vulnerable to opportunistic behaviour by individuals in both the public and the private sectors. Thus, at the onset of the 21st century, the consensus on the economic role of government in capitalism shifted back from the social democratic interventionism of the [Keynesian](#) system and the managed market economies of the “Asian tigers” (countries such as Hong Kong, Singapore, Malaysia, and South Korea that experienced rapid growth in the late 20th century) to the more noninterventionist model of Adam Smith and the classical economists.

It is not necessary, however, to venture risky predictions concerning economic policy. Rather, it seems more useful to posit two generalizations. The first emphasizes that capitalism in all its variations continues to be distinguished from other economic systems by the priority accorded to the drive for wealth and the centrality of the competitive mechanism that channels this drive toward those ends that the market rewards. The spirit of enterprise, fueled by the acquisitive culture of the market, is the source of the dynamism of capitalism. The second generalization is that this driving force and constraining mechanism appear to be compatible with a wide variety of institutional settings, including substantial variations in the relationships between the private and public sectors. The form of capitalism taken also differs between nations, because the practice of it is embedded within cultures; even the forces of [globalization](#) and the threat of homogenization have proved to be more myth than reality. Markets cater to national culture as much as national culture mutates to conform to the discipline of profit and loss. It is to this very adaptability that capitalism appears to owe its continued vitality.

Criticisms of capitalism

Advocates and critics of capitalism agree that its distinctive contribution to history has been the encouragement of [economic growth](#). Capitalist growth is not, however, regarded as an unalloyed benefit by its critics. Its negative side derives from three dysfunctions that reflect its market origins.

The [unreliability of growth](#)

The first of these problems is already familiar from the previous discussion of the stages of capitalist development. Many critics have alleged that the capitalist system suffers from inherent instability that has characterized and plagued the system since the advent of industrialization.

Because capitalist growth is driven by profit expectations, it fluctuates with the changes in technological or social opportunities for capital accumulation. As opportunities appear, capital rushes in to take advantage of them, bringing as a consequence the familiar attributes of a boom. Sooner or later, however, the rush subsides as the demand for the new products or services becomes saturated, bringing a halt to investment, a shakeout in the main industries caught up in the previous boom, and the advent of [recession](#). Hence, economic growth comes at the price of a succession of market gluts as booms meet their inevitable end.

This criticism did not receive its full exposition until the publication of the first volume of Marx's *Das Kapital* in 1867. For [Marx](#), the path of growth is not only unstable for the reasons just mentioned—Marx called such uncoordinated movements the “anarchy” of the market—but increasingly unstable. Marx believed that the reason for this is also familiar. It is the result of the industrialization process, which leads toward large-scale enterprises. As each saturation brings growth to a halt, a process of winnowing takes place in which the more successful firms are able to acquire the assets of the less successful. Thus, the very dynamics of growth tend to concentrate capital into ever-larger firms. This leads to still more massive disruptions when the next boom ends, a process that terminates, according to Marx, only when the temper of the working class snaps and capitalism is replaced by socialism.

Beginning in the 1930s, Marx's apocalyptic expectations were largely replaced by the less-violent but equally disquieting views of the English economist [John Maynard Keynes](#), first set forth in his influential *The General Theory of Employment, Interest, and Money* (1936). Keynes believed that the basic problem of capitalism is not so much its vulnerability to periodic saturations of investment as its likely failure to recover from them. He raised the possibility that a capitalist system could remain indefinitely in a condition of equilibrium despite high unemployment, a possibility not only entirely novel (even Marx believed that the system would recover its momentum after each crisis) but also made plausible by the persistent unemployment of the 1930s. Keynes therefore raised the prospect that growth would end in stagnation, a condition for which the only remedy he saw was “a somewhat comprehensive socialization of investment.”

The quality of growth

A second criticism with respect to market-driven growth focuses on the adverse side effects generated by a system of production that is held accountable only to the test of profitability. It is in the nature of a complex industrial society that the production processes of many commodities generate “bads” as well as “goods”—e.g., toxic wastes or unhealthy working conditions as well as useful products.

The catalog of such market-generated ills is very long. Smith himself warned that the [division of labour](#), by routinizing work, would render workers “as stupid and ignorant as it is possible for a human creature to become,” and Marx raised the spectre of [alienation](#) as the social price paid for subordinating production to the imperatives of profit making. Other economists warned that the introduction of technology designed to cut labour costs would create permanent [unemployment](#).

In modern times much attention has focused on the power of physical and chemical processes to surpass the carrying capacity of the environment—a concern made cogent by various types of environmental damage arising from excessive discharges of industrial effluents and pollutants. Because these social and [ecological challenges](#) spring from the extraordinary powers of technology, they can be viewed as side effects of socialist as well as capitalist growth. But the argument can be made that market growth, by virtue of its overriding obedience to profit, is congenitally blind to such externalities.

Equity

A third criticism of capitalist growth concerns the fairness with which capitalism distributes its expanding [wealth](#) or with which it shares its recurrent hardships. This criticism assumes both specific and general forms.

The specific form focuses on disparities in income among layers of the population. At the turn of the 21st century in the United States, for example, the lowest fifth of all households received only 3.6 percent of total income, whereas the topmost fifth received 49 percent. Significantly, this disparity results from the concentration of assets in the upper brackets. Also, the disparity is the consequence of highly skewed patterns of corporate rewards that typically give, say, chief executive officers of large companies 50 to 100 times more income than those of ordinary office or factory employees. Income disparities, however, should be understood in perspective, as they stem from a number of causes. In its 1995 annual report the Federal Reserve Bank of Dallas observed,

By definition, there will always be a bottom 20 percent, but only in a strict caste society will it contain the same individuals and families year after year.

Moving from specific examples of distribution to a more general level, the criticism may be broadened to an indictment of the market principle itself as the regulator of incomes. An advocate of market-determined distribution will declare that in a market-based society, with certain exceptions, people tend to be paid what they are worth—that is, their incomes will reflect the value of their contribution to production. Thus, market-based rewards lead to the [efficiency](#) of the productive system and thereby maximize the total income available for distribution. This argument is countered at two levels. Marxist critics contend that labourers in a capitalist economy are systematically paid less than the value of their work by virtue of the superior bargaining power of employers, so that the claim of efficiency masks an underlying condition of exploitation. Other critics question the criterion of efficiency itself, which counts every dollar of input and output but pays no heed to the moral or social or aesthetic qualities of either and which excludes workers from expressing their own preferences as to the most appropriate decisions for their firms.

Corrective measures

Various measures have been taken by capitalist societies to meet these criticisms, although it must be recognized that a deep disagreement divides economists with respect to the accuracy of the criticisms, let alone the appropriate corrective measures to be adopted if these criticisms are valid. A substantial body of economists believe that many of the difficulties of the system spring not from its own workings but from well-meaning attempts to block or channel them. Thus, with respect to the problem of instability, supporters of the market system believe that capitalism, left alone as much as possible, will naturally corroborate the trend of economic expansion that has marked its history. They also expect that whatever instabilities appear tend quickly to correct themselves, provided that government plays a generally passive role. Market-oriented economists do not deny that the system can give rise to qualitative or distributional ills, but they tend to believe that these are more than compensated for by its general expansive properties. Where specific problems remain, such as damage to the environment or serious poverty, the prescription often seeks to utilize the market system itself as the corrective agency—e.g., alleviating poverty through negative income taxes rather than with welfare payments or controlling pollution by charging fees on the outflow of wastes rather than by banning the discharge of pollutants.

Opposing this view is a much more interventionist approach rooted in generally [Keynesian](#) and welfare-oriented policies. This view doubts the intrinsic momentum or reliability of capitalist growth and is therefore prepared to use active government means, both fiscal and monetary, to combat recession. It is also more skeptical of the likelihood of improving the quality or the equity of society by market means and, although not opposing these, looks more favourably on direct regulatory intervention and on specific programs of assistance to disprivileged groups.

Despite this philosophical division of opinion, a fair degree of practical consensus was reached on a number of issues in the 1950s and '60s. Although there are differences in policy style and determination from one nation to the next, all capitalist governments have taken measures to overcome recession—whether by lowering taxes, by borrowing and spending, or by easing interest rates—and all pursue the opposite kinds of policies in inflationary times. It cannot be said that these policies have been unqualified successes, either in bringing about vigorous or steady growth or in ridding the system of its inflationary tendencies. Yet, imperfect though they are, these measures seem to have been sufficient to prevent the development of socially destructive depressions on the order of the Great Depression of the 1930s. It is not the eradication but the limitation of instability that has been a signal achievement of all advanced capitalist countries since World War II. It should be noted, however, that these remedial measures have little or no international application. Although the [World Bank](#) and the [International Monetary Fund](#) make efforts on behalf of developing countries, no institution exists to control credit for the world (as do the central banks that control it for individual nations); no global spending or taxing authority can speed up, or hold back, the pace of production for industrial regions as a whole; no agency effectively oversees the availability of credit for the developing nations or the feasibility of the terms on which it may be extended. Thus, some critics of globalization contend that the internationalization of capitalism may exert destabilizing influences for which no policy corrective as yet exists.

A broadly similar appraisal can be made with respect to the redress of specific threats that emerge as unintended consequences of the market system. The issue is largely one of scale. Specific problems can often be redressed by market incentives to alter behaviour (paying a fee for returning used bottles) or, when the effect is more serious, by outright prohibition (bans on child labour or on dangerous chemical fertilizers). The problem becomes less amenable to control, however, when the market generates unintended consequences of large proportions, such as traffic congestion in cities. The difficulty here is that the correction of such externalities requires the support and cooperation of the public and thereby crosses the line from the economic into the political arena, often making redress more difficult to obtain. On a still larger scale, the remedy for some problems may require international agreements, and these often raise conflicts of interest between the nation generating the ill effects as a by-product of its own production and those suffering from the effects. The problem of acid rain originating in one country but falling in another is a case in point. Again the economic problem becomes political and its control more complicated.

A number of remedies have been applied to the distributional problems of capitalism. No advanced capitalist country today allows the market to distribute income without supplementing or altering the resulting pattern of rewards through taxes, subsidies, welfare systems, or entitlement payments such as old-age pensions and health benefits. In the United States, these transfer payments, as they are called, amount to some 10 percent of total consumer income; in a number of European nations, they come to considerably more. The result has been to lessen considerably the incidence of officially measured poverty.

Yet these examples of successful corrective action by governments do not go unchallenged by economists who are concerned that some of the “cures” applied to social problems may be worse than the “disease.” While admitting that the market system fails to live up to its ideal, these economists argue that government correctives and collective decision making must be subjected to the same critical scrutiny leveled against the market system. Markets may fail, in other words, but so might governments. The stagflation of the 1970s, the fiscal crises of some democratic states in the 1980s, and the double-digit unemployment in western Europe in the 1990s set the stage for the 21st century by raising serious doubts about the ability of government correctives to solve market problems.