

## CHAPTER 3

# THE CAPITALIST MARKET: HOW IT IS SUPPOSED TO WORK

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The American economy is a special case of capitalism. In order to understand how the American economy works, therefore, we will need to spend some time talking in more general terms about the nature of capitalism as an economic system, and this in turn means we will have to discuss a number of fairly abstract ideas and develop a number of theoretical tools, many of which come from economics. This will be the main task of this chapter and the next. In this chapter we will begin by defining capitalism as an economic system and then examine the central arguments in favor of capitalism by its defenders. This will give us a picture of how capitalism is *supposed* to work. In the following chapter we will discuss some of the dilemmas and problems of capitalism as an economic system which explains its limitations and failures. The chapters which follow, then, apply these ideas to a number of more specific problems in the American economy today: the environment, transportation, health care, consumerism, and training. The central theme in each of these analyses is how the over-reliance on capitalist markets in the American economy produces inefficient outcomes. Our exploration of the American economy concludes in Chapter 9 by outlining a range of institutional innovations which might contribute to resolving these problems by strengthening the role of democratic governance and collaborative problem solving over economic processes.

### **I. What is a Capitalist Free Market Economy?**

Economic life can be organized in many ways. This is a crucial idea: history contains an enormous variety of ways of organizing economic activity and, undoubtedly, there are possibilities that have not yet happened but eventually will. The first step in giving more precision to our understanding of capitalism as a specific way of organizing an economy is to get some appreciation of this broader variation.

Here are a few examples of non-capitalist economic structures:

*Feudalism.* In Feudal economies, the key economic resource is land. Different classes of people have different kinds of rights and relationship to the land. Peasants are “tied” to the land: they do not have the right to simply leave. They have the right to farm the land, but in order to do so they have to give a certain proportion of their production to feudal lords. Sometimes this takes the form of feudal peasants working part of the time on land directly controlled by lords and part of the time on land which they control; in other situations, a certain proportion of their product is taken in the form of a rent. Unlike in market economies, they are not free to make their own choices about what to do.

*Slavery.* In slavery people are the private property of other people and are owned in the same sense that a farm animal can be owned. This is different from feudalism, in which peasants have specific kinds of rights to the land and specific forms of autonomy, under the constraints of their obligations to lords. In slavery that autonomy and those rights disappear entirely.

*Simple market economy.* In a simple market economy, most producers own their own means of production and produce both for their own consumption and for the market. There is not really a labor market since people work for themselves, not for others, except perhaps as a transient state.

*State bureaucratic socialism.* In state bureaucratic socialism, such as in the Soviet Union in most of the 20<sup>th</sup> century, the state owns all of the important means of production and state officials of various sorts make the basic decisions about investment, production, technology, and so on. The economy is run through some kind of centralized planning process.

*Other possibilities?* There may be many other ways of organizing the economy that have not really been tried on a wide scale. Some people have argued for the possibility of what is sometimes called “market socialism”. One form this might take is an economy in which firms are owned by their employees, not by capitalists, but production is still oriented towards the market. Other people have argued for a state-owned economy, but one that is organized in a highly decentralized and democratic manner in which planning was less the business of central planners and more of citizen participants in various kinds of planning processes. Neither of these may be realistic, but what we know almost for sure is that there are possibilities beyond those that we have observed in history so far.

Capitalism, then, is one of the many historically variable ways that economic systems can be organized. As discussed in Chapter 2, it is defined by three principle conditions: production is organized for the market; the means of production are privately owned; and the people who use those means of production to produce goods and services are hired on a labor market to work in firms as employees. Defined in this way capitalism is *not* identical to the idea of a “market economy.” To be sure, capitalism is organized through markets, but not all market economies are capitalist. In the examples above, a simple market economy has markets and private ownership, but the producers are self-employed owners rather than employees. State owned firms, rather than privately owned firms, can produce for a market, and this too would not be capitalism. Slave plantations in the United States before the Civil War produced cotton for the market, but slavery itself was not a form of capitalism. Capitalism is different from all of these. It is that form of market economy in which the units of production – firms – are privately owned and the work in production is performed by employees.

The United States economy is strongly dominated by capitalism, more so than most other countries in the world. But it would be a very big mistake to say that it has a purely capitalist economy. Many aspects of production and distribution in the United States are organized in decidedly non-capitalist ways: educational services are provided by public schools; the Veterans Administration produces healthcare services for a part of the population; many cities have publicly produced mass transit; churches, civic associations and other non-profit organizations provide a wide range of services within communities; significant aspects of the information produced and distributed through the internet are done in what is termed “open source” processes based on voluntary activity and nonmarket coordination; and a great deal of caregiving and meal preparation is done within households for direct consumption. All of these are instances of noncapitalist economic activity.

A nice illustration of the difference between capitalist and noncapitalist ways of organizing economic activity is the contrast between two ways in which people get access to books: bookstores and libraries. The United States turns out to have one of the best developed public library systems in the world. Ironically, perhaps, this system was largely founded through the

philanthropy of one of the wealthiest and most powerful capitalists of the late 19<sup>th</sup> century, Andrew Carnegie. What are the key differences between bookstores and libraries? When you enter a bookstore in search of a book you go to the part of the store in which the book is shelved, take it off the shelf, look at its price, and then decide whether or not it is worth it to you to spend that amount of money to have the book. Your access to the book is governed by your willingness (and ability) to pay for it. In a library you go to the shelf, see if the book is there. If it is, you take it and check it out. If it is not, you put your name on a waiting list and get notified when the book is available. The access to the book is rationed by time: your willingness to wait for it. The librarian then notes how long the waiting list is and, depending upon the resources of library, the level of community support for its activities, and its policies concerning waiting lists, decides whether or not to order more copies of the book.

The underlying principles of libraries and bookstores are thus quite different. The underlying principle of access to books in the library is “to each according to need,” while the principle in the bookstore is “to each according to ability to pay.” These two mechanisms have very different consequences in the world. Libraries are clearly more egalitarian in the sense that they embody an ideal of equal opportunity for all. No one is at a disadvantage because of personal resources. If bookstores were the only way of getting books, then poor people would have much less access to books. One can easily imagine libraries being used for all sorts of things besides books – movies, recordings, artwork, tools, video cameras, etc. And indeed, some public libraries in the United States do provide some of these. Imagine how the American economy would be different if libraries were ever to become a general, pervasive model for access to such a wide range of things?

So, the United States is definitely not a purely capitalist economy. Nevertheless, in the spectrum of developed capitalist countries in the world today, it is on the end of the continuum in which capitalism is strongest. And most Americans think that this is a good thing. Most Americans are suspicious of government regulation, let alone public ownership, and many, perhaps most, believe that relatively unfettered markets and private enterprise are the best way of organizing economic activity. It will help us understand how the American economy works and what are its problems by laying out the central lines of defense of a free market capitalist economy, and the basic argument underlying the skepticism about the role of Government in regulating economic life. This is the task of the rest of this chapter.

## II. Arguments for Capitalism

Defenders of free market capitalism generally make two kinds of arguments. The first is a moral argument: If you truly value individual freedom, this is the most freedom-enhancing way to organize economic life. All other ways of running an economy involve more coercion of the lives of individuals in ways that violates their liberty. The second is a pragmatic argument: the free market and unfettered private ownership is the most efficient way of organizing the economy. It delivers the goods. Let us briefly look at the first of these, and then in more detail the second, since in the end it is main way that capitalist institutions are defended.

### 1. The Moral Argument

The moral defense of capitalism is usually associated with what is called *libertarianism*. The basic idea is quite simple: Individual freedom is the paramount social value, where freedom is mainly understood in terms of what is sometimes called “negative freedom,” the freedom from coercion by other persons or organizations. In this sense of freedom, you are “free” if no one can

tell you what to do without your consent. Both you and a media tycoon have the “same” freedom of speech since no one tells you what to say. Unfettered markets are thus morally good things because in a market buyers and sellers meet and voluntarily make exchanges without coercion.

The moral defense of capitalism is simply a logical extension of these arguments about voluntary exchange on free markets. If people are free, then they should be allowed to use their property however they like so long as this does not interfere with anyone else’s property rights. This means that owners of the means of production should be free to use their capital as they wish, and in particular, they should be free to hire workers to use those means production on any terms voluntarily agreed upon by the workers and employers. So long as all of the agreements are voluntary – no one is directly forced by someone else to sign a contract – this is an expression of individual freedom and autonomy. Restrictions of voluntary contracts – including restrictions governing things like working conditions, pay, rights to hire and fire, and so on – are all violations of this conception of freedom. A minimally regulated capitalism is the form of economic organization that best satisfies these moral principles.

## 2. The Pragmatic Argument for capitalism

There are two broad pragmatic arguments for capitalism as a way of organizing economic activities: first, capitalism provides the most effective way of coordinating a complex economic system, and second, it creates powerful incentives for innovation and economic growth. The full arguments underlying these claims involve quite a lot of complex economic theory, but the basic ideas are relatively simple.

### *Coordination*

The first pragmatic argument for capitalism centers on a crucial problem faced by any complex economic system: how to effectively coordinate the economic activities of widely dispersed people in such a way that their activities fit together reasonably well. You want to build a house. You need lumber, nails, wire, ceramic tiles, paint, carpets and many other things, as well as a variety of tools and machines. All of these “inputs” into your housebuilding were themselves produced with machines and energy and many raw materials from all over the world involving tens of thousands of people engaged in laboring activity. How do you let these people know that you want a particular kind of nail and a particular variety of lumber, and that you need these on a particular date in order to build your house? It is an unbelievably complex matter to get all of this activity even moderately well coordinated. The most basic defense of capitalism as an economic system says that a market economy based on decentralized privately owned firms is the best way to solve this problem. How is this supposed to work?

In a stylized way we can think of two primary methods of solving this complex coordination problem. One solution is *planning and command*, the other is *decentralized markets*. In a planning model, activities of individuals and firms are coordinated by a planning authority telling people what to do. This is how coordination takes place in some large organizations and corporations: there is a hierarchy of managers with various responsibilities for figuring what to do, and they issue orders to subordinates which ultimately set in motion specific activities of people at the bottom. This is also, more or less, how economic coordination worked in the Soviet Union: central planners formulated plans, allocated resources to firms, and instructed those firms what to produce. Authoritative command works reasonably well in some contexts, but it has proven very problematic when applied to large and complex systems. Even apart from the problem that a system of comprehensive planning and control of a complex economy seems to

violate the values of individual freedom and autonomy, the task seems impossibly complex and likely to produce massive inefficiencies.

Decentralized markets with privately owned enterprises is the principle alternative to centralized planning as a way of solving this massive coordination problem. The story about how this coordination is accomplished was first systematically elaborated by Adam Smith in his famous account of the “invisible hand” of the market. Even if, in the end, we discover that this story is far too simple and that the free market does not really function in the way Adam Smith believed, nevertheless it is a remarkable account and remains the core of the pragmatic defense of capitalist institutions today.

The key idea in the theory of the invisible hand of market coordination is the notion of “prices” as a mechanism for supplying both information and incentives to people in such a way that their activities can be coordinated. “Price” is a pretty odd phenomenon if you think about it: you take two things, an apple and a hammer and a number gets assigned to each which tells you how many apples are worth the same as one hammer: 10 apples = 1 hammer.

How, then, do prices of things work to coordinate a vastly complex system of decentralized economic activity? The conventional story revolves around the way the interplay of supply and demand shapes the movement of prices: If, at the existing price of widgets, there are more people who want widgets than the supply of widgets, then the price will rise because people who want widgets will bid the price up. This creates a big incentive for producers of widgets to produce more, since the higher prices mean that they will make a greater profit. Production of widgets thus increases, the supply rises, and eventually as supply equals demand, the prices fall. Eventually no one is willing to produce more widgets at the going price, which means that the price must be pretty close to the cost of producing widgets. This is called by economists an “equilibrium” -- a situation where price and quantity remain stable because no one has an incentive to change their behavior.

This interplay of supply and demand through the mechanism of price this leads to what economists call *allocative efficiency*: resources and activity are allocated to different purposes in such a way that the amount of different sorts of things that get produced is exactly the right amount given what people want and how much money they have. The degree of coordination this involves is really amazing: When you go to a store and buy a chocolate bar you are giving information to the store owner who automatically passes that information to the chocolate bar company in the form of new orders of candy bars; the candy bar manufacturer then communicates the information to the cocoa importer when ordering new supplies; and the importer ultimately passes this information to the farmer in West Africa growing the cocoa beans. Each of these actors in the chain has a personal incentive to respond to the information. When you buy a candy bar you are, through a chain of information and incentives, communicating with a farmer in Africa.

Defenders of capitalism, emphasize two important implications of the way capitalist markets accomplish this broad economic coordination. First, if capitalist markets work this way, then the underlying dynamics of the economy is driven by the preferences and behaviors of consumers. This is generally referred to as “consumer sovereignty”. Producers – whether they be giant multinational corporations or small firms – have powerful incentives to respond to information given them by the consumers of their products. If they fail to respond to that information, they lose money. It is thus the final consumers of the goods and services produced by the economic system who have the most fundamental power, since it is their preferences and choices which set

in motion the information and incentive system which coordinates market. This is appealing, since it corresponds to popular ideas about individual autonomy and freedom: apparently powerful corporations are really controlled by consumers.

The second implication is a particular (some people would say *peculiar*) sense in which capitalist markets do not simply do a pretty good job in coordinating a complex system of economic activity, but they do so in a way that is “optimal”. To say that a particular way of doing things is optimal is to say that it is as good as possible, that any other alternative would produce worse results. In an ideal capitalist free market, when one person makes an offer to exchange something, if someone accepts the offer, then they both are better off; if no one accepts the offer it is because no one could be made better off by the exchange. If you let everyone freely make exchanges, then eventually you will reach an “equilibrium” in which no further exchanges happen. This is a situation in which *no one can improve without someone else being worse off*. This kind of situation has a special name in economics: “Pareto optimality”, named after the 19<sup>th</sup> century Italian economist, Wilfredo Pareto. The claim of defenders of the free market is that if the market is allowed to work freely it will generate a distribution of goods that satisfies this condition of Pareto optimality.

### ***Innovation and growth***

As many advocates of free markets stress, unfettered capitalist markets are not simply an efficient way of allocating *existing* resources; they also promote all sorts of innovations, both innovations which contribute to economic growth by improving human productivity and innovations in products which improve the quality of life. This is thought to be the real magic of capitalism: capitalist markets generate a dynamic economic system which ultimately improves the lives of people through innovation and growth.

There are three core reasons for this innovative dynamic: First, the market rewards people and firms financially for making the right decisions and punishes them for making the wrong decisions, where “right” means both producing things people want to buy and producing them at lower cost so more people can afford them. Second, the market allows people and firms to take risks in order to obtain the rewards which markets potentially offer. Innovation is a gamble, and markets provide one way of letting people engage in gambles which potentially have significant social benefits in the form of new products and technological improvements. Third, competition among firms intensifies both of these processes: Capitalist markets put considerable pressure on firms to innovate in order to survive against competition. Over time this means that firms that innovate successfully will tend to expand and those which do not will decline, thus increasing the pressure on less successful firms adopt existing innovations and seek new ones. The result is that innovations tend to diffuse throughout an economic system, thus raising productivity and underwriting significant economic growth.

Risk-taking is key here, for most innovations are the result of investing time, energy and resources without any assurance these will generate a pay off. Of course, capitalist markets are not the only way of encouraging socially-useful risk-taking. Much research, for example, is conducted in academic institutions and government research institutes in which risks are taken and considerable innovation occurs, animated not by the potential of making huge amounts money, but rather by desires for reputation and the opportunity to do interesting work that contributes to knowledge and public welfare. Still, capitalist markets have proven to be a powerful engine for innovation through the combination of competitive pressures and opportunities for financial payoffs to successful risk-taking. Particularly because of the ways in

which capitalism facilitates such broadly decentralized and diffused forms of risk-taking and innovation in which the initiative and inspiration of creative individuals get linked to financial resources of investors, capitalism has proved to be an engine of economic growth.

### III. Arguments against state interference with the market

The moral and pragmatic defense of capitalism involves not simply an affirmation of the virtues of capitalism, but also a critique of the state. “The Government which governs least governs best” is a standard aphorism of advocates of capitalist systems.

The moral argument against the state is simpler than the pragmatic argument and is most purely embodied in libertarian thought. Governments rule by command backed up by force. Governments are therefore inherently a threat to freedom; the sheer fact of the state implies a restriction on freedom. This does not mean that Governments should be abolished – most advocates of unfettered markets are not anarchists. But they believe that the role of government should be strictly circumscribed and the burden of proof is always on those who say the government should do something. The state should be what is sometimes called “a Nightwatchman state” rather than an “Affirmative State”, a state whose role is limited as much as possible to the task of protecting property rights and the rules of the game rather than actively intervening in the economy to “solve” problems.

While the moral argument for a limited state has appeal to libertarians, this by itself would not be persuasive to many, perhaps most, people. People see many problems in American society – poverty, pollution, inadequate health care, to name only a few – and at various times in American history people have turned to the state for help. Opponents of a strong role for the state in a market economy have thus given considerable weight to the pragmatic argument. “The state is the problem, not the solution,” is another aphorism.

Two kinds of pragmatic arguments are particularly common in the attacks on state intervention. These can be referred to as the thesis of *state incompetence* and the thesis of *state malevolence*.

The state incompetence thesis suggests that government bureaucracy is inevitably clumsy and ineffective, bogged down in “red tape” and a preoccupation with one-size fits all rules and regulations. Politicians and government officials may be well-meaning, but their attempts at imposing regulations on the market almost always backfire, undermining the crucial incentives that generate efficiency in market. Efforts at environmental protection, for example, generate endless paperwork, environmental impact studies, rigid rules that fail to take into account local conditions, and endless litigation. Even if the goals were worthy, the effects are undesirable.

The state malevolence thesis is much stronger. Here the state is not just viewed as all thumbs and no fingers, but as an iron fist. Bureaucrats strive to accumulate power either for its own sake or to serve their own career interests. Corruption is a chronic problem, not just in the sense of politicians and bureaucrats taking bribes (although this happens often enough) but in the sense of state officials protecting powerful economic actors from market competition through subsidies, tax breaks and self-serving regulations in exchange for their political support. The state is either captured by special interests which use the power of the state to gain special advantages, or it is an autonomous machine bent on domination for domination’s sake. Perhaps the original intention of building up this machine was benevolent, seeking the means to solve real problems. But once created this state machine becomes Frankenstein, a monster which cannot be controlled by its creator. Only if the monster is slain can the full virtues of capitalism be unleashed.

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It would be an exaggeration to say that most Americans fully accept these libertarian arguments against the state and for a largely deregulated free market form of capitalism. Public opinion surveys consistently indicate much more ambivalence than this. Americans typically believe in democracy and the need for a state that does much more than just enforce the rules of the game, and while they are strong supporters of private enterprise and market capitalism, there is considerable skepticism that an unregulated, free-for-all market is the best for securing either freedom or efficiency. In the next chapter we will examine a range of problems generated by market capitalism which markets by themselves cannot solve.