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Smith, Marx and Weber

Adam Smith (1723–1790): the market as a harmonizing 'invisible hand'

Published in 1776, Adam Smith's *The Wealth of Nations* was an attempt to explain western Europe's unprecedented acceleration in economic growth. Before this time, the wealth of a nation was relatively easy to explain – it was largely the result of the 'visible hand' of military power. Countries might differ in their endowments – such as climate, the fertility of the land and natural resources – but these advantages could always be obtained by conquest. Economic power was evidently a consequence of military power. By and large, rulers subscribed to the mercantilist doctrine which held that power should be founded on amassing and hoarding wealth within a territorial state. For some, even the export trade was interpreted as a loss of resources that, furthermore, might even strengthen an enemy.[1]

From the late seventeenth century onwards developments seemed to contradict this doctrine and to lend support to alternative explanations of the rise and fall of states. By the middle of the eighteenth century it was becoming apparent that the progression of society through a succession of increasingly wealthy stages of development could not be explained simply as the result of powerful rulers' conscious intent. Arguably the most mercantilist of all European states, Spain, was eventually brought down by a small country with negligible natural material resources of its own – Holland (Smith 1986 [1776]: 473). Here, the relationship between military and economic power was seemingly reversed. Whilst Spain had sought power by the conquest and seizure of south American silver, the Dutch East India Company's trading ventures produced the wealth that supported an expansion of military power. Successful wealthy European societies, Smith argued, were entering a new stage of economic development – based on 'commerce'.[2] Here, the creation of wealth was the result of myriad individuals pursuing their own interests, not the strategies of powerful rulers. Consequently, the two fundamental economic questions – the growth of wealth and its distribution – now required a quite different explanation.

Smith's answer to the questions is provided by his analysis of the interrelationship between three elements of 'commercial' society – *factors of production*, *the market* and *the state*. *The Wealth of Nations* was the first comprehensive examination of the emerging market capitalist system, and it remains enormously influential (Smith 1986 [1776]). It was written before the growth of industrial capitalism – that is to say, before factory production in large externally financed corporations. Rather, Smith was concerned with the first significant structural change in the evolution of the modern economy – the rapid development of market exchange. By the eighteenth century, the closed self-sufficient economic systems of the household and manor had given way to the market mechanism in which wages and prices were rapidly replacing traditional reciprocity and redistribution.[3] Moreover, Smith saw that there was a direct link between this expansion of the market and the division of labour. Extensive specialization of task and economic function eliminates the self-sufficiency of household and manor, making market exchange necessary, which in turn permits further specialized, divided labour and, consequently, greater efficiency and economic growth.

The factors of production

Commercial society comprises two sectors – agriculture and manufacture, in which capital (or stock), comprising mainly the instruments of production, employs labour (Smith 1986 [1776]: Book II). This gives commercial society its three factors of production – land, capital and labour. This fundamental division of function is the basis for 'three great constituent orders' of society – landlords, capitalists and labourers. Their mutual dependence can be traced through the exchange relations between rents, profits and wages in a 'circular flow' of production, income and expenditure. The capital stock provides the wages for the worker's expenditure and consumption of the production, which, in turn, creates profit, more capital and so on.

The division of labour and market exchange

The basic mechanism of the commercial system is the division of labour, the mutual dependence of the separate parts and their consequent need to exchange their products. Unlike feudal obligation or the compulsion of slavery, interdependency – that is, the connection between the parts – in commercial society is based upon the market price of the respective factors that are freely established in what Smith referred to as the 'perfect liberty' of exchanges.

Within each of the three divisions of society – land, capital and labour – there is further specialization of function or task. Smith illustrated the advantages of specialization in raising the productivity of labour with the example of the eighteen distinct operations performed by different workers in the manufacture of nails (Smith 1986 [1776]: 112–13).

Coordination of the complex functionally differentiated system is accomplished spontaneously by the 'invisible hand' of the market – that is, the interaction of supply and demand that represents the decisions of myriad otherwise unconnected individuals. The rise and fall of prices signal the existence of either scarcity or abundance to producers and consumers, whose self-interest ensures that any imbalances are corrected. For example, capital is attracted to sectors with rising prices and profits, causing them to fall as a result of the increase in competition. If left to operate unhindered, the invisible hand ensures that the 'circular flow' of production, income and expenditure, and the supply and demand for goods, will move to an equilibrium at which incomes and revenues from production cover costs, and all resources are fully employed.

However, the market was not merely a self-regulating economic mechanism; it was also a means of social integration. Exchange cemented society in networks of mutually advantageous interdependence, and it could also be seen as resolving the eternal ethical question of the relationship between individual conduct and the general collective welfare. If self-interest led to the wealth of nations, then, as Mandeville had expressed it earlier in his *Fable of the Bees* (1714), 'private vices' were the source not only of 'public benefits' but also of 'public virtue'.

This conclusion about the efficacy of the market depends on the important assumption that individuals do not wish to store wealth in the form of money. In his opposition to the mercantilist doctrine that the power of states is enhanced by the accumulation of precious metal money rather than the pursuit of commerce, Smith relegated money to a secondary, passive role in his analytical system. It was irrational, Smith contended, to hold money when it could either be used to obtain capital investment goods (fixed capital and stock) in order to make profits or spent to satisfy wants. Hoarded precious metal money was unproductive; for Smith, money should be nothing more than a medium to facilitate market exchange. This 'great wheel of circulation' was not to be confused with the real wealth of society that resided in the factors of production and goods that it circulated (Smith 1986 [1776]: 385).[4]

Commerce, politics and the state

In his polemic against the claims of absolutist monarchies and their false mercantilist policies, Smith relegated politics and the state to a minimal role in economic affairs. In the first place, the idea of the invisible hand's harmonization of individual and societal welfare was incompatible with politics understood as conflict between inherently opposed interests. Second, his insistence that economic coordination and wealth creation were the spontaneous, unintended consequences of self-regarding individuals in the marketplace was aimed at demonstrating that the state's direct involvement in economic activity was counterproductive. Governments must leave economic decision-making to individuals in the 'perfect liberty' of the competitive market.

This does not mean, as is all too commonly assumed, that the state is unimportant for Smith. On the contrary, he saw that it performed three indispensable roles in the commercial stage of society (Smith 1986 [1776]: Book V). First, the state should provide for the defence of the territory in which perfect liberty could be exercised. Second, and to the same end, the state must uphold the rule of law. Without secure property rights over the use and disposal of goods and capital the market cannot function. Third, the state should provide certain 'public goods' that it may never be profitable for individuals to produce 'privately' (see the discussion of 'public goods' in chapter 5). Smith's short list of 'public goods' refers mainly to infrastructure, such as roads, bridges, harbours and canals, where the level of capital investment and the difficulty of setting prices and of collecting revenue deter private provision. But he remained convinced that wherever possible general public services were better performed when supplied in the pursuit of profit by private entrepreneurs.

As we shall see, this partial qualification of the invisible hand's efficacy opens up the possibility that the state may be required under certain circumstances to play a more extensive economic role, or even replace the market mechanism. Smith was writing at a time when most goods and services could be more easily provided privately, as they required relatively less capital investment and coordination than today. Despite the recent privatization of public services in advanced capitalist economies, the modern state's role in financing public works, as we shall see, is far greater than it was in Smith's day. Rail transport, for example, is widely accepted in many, if not quite all, developed economies as being most effectively and efficiently run by the state. Furthermore, the deleterious environmental consequences of industrialism, financial crises and protracted economic depressions were less apparent in the middle of the eighteenth century.

Eventually, states were called upon to try to deal with what modern economists refer to as 'negative externalities' and 'market failure' (see the discussions in chapters 5 and 8). (But, eighty years or so after the publication of *The Wealth of Nations*, Karl Marx, as we shall see, had formed a clear view of the negative consequences of the 'perfect' economic liberty of commercial society.)

Value and distribution

The question of the source of value and its distribution remains the subject of an intense debate in economic theory that cannot be discussed here in any detail. Rather, the present aim is to focus on how Smith's answers disclose his conception of the structure of the emerging capitalist society – that is, his attempt to make the operation of the guiding 'hand' more visible to us.

Just as the power of states and their sovereigns no longer provided wholly satisfactory explanations of the growth of the wealth of nations, it could no longer account for its distribution among the three great constituent orders of society and labour's different occupations (Smith 1986 [1776]: 134). Commerce and industry had at least partially overturned traditional hierarchies based on religious sanction and political power. For example, the mediaeval scholastics' attempt prescriptively to regulate economic life with 'just prices' and the prohibition of unethical practices such as usury had long since been abandoned. But the question remained: why and how did the apparently free and equal exchange in the 'perfect liberty' of the market result in inequality? It remains, as we shall see, a central issue in the politics of modern capitalist democracies.

In a similar manner to the explanation of wealth creation as a spontaneous outcome of the market, Smith and the classical economists sought to locate the mechanism for the distribution of income among the factors of production (land, labour and capital) and the specialized occupations in the actual structure of the division of labour itself. Inequality was produced by the impersonal, and implicitly neutral, mechanism of the 'invisible hand', not by directly coercive exploitation as it had been in feudal society. The relative shares of rents, wages and profits were determined by their exchange value – that is, the price that had to be freely paid for the use of land, labour and capital for production.

Smith distinguished between the *natural* price – that is, that which exactly covers costs of production – and the *market* price, which is determined by scarcity and the balance of supply and demand at any point in time. The two prices frequently diverge in the short term, but in the long run the competitive market ensured their convergence. For example, if the market price were too low to cover costs, then the enterprise or sector would fail. On the other hand, if the market price met these with ease, then, as we have noted, more enterprise would be attracted to the sector in pursuit of easy profits, increasing both competition and supply and, consequently, reducing prices. In modern economic terminology, the economy would move towards equilibrium (Smith 1986 [1776]: chapter VII). At this point, the relative share of the distribution of income between the three factors and their respective occupations is that which brings about the full employment of society's resources. In this situation, produced by free exchange, the factors of production would receive precisely the return which rewarded their contribution to this perfect balance. Any other distribution would perturb the equilibrium. In the long run, rent, wages and profits were equivalent to the value of their contribution to the aggregate wealth. Not only was the 'invisible hand' efficient, it was also just and fair.[5]

Smith's legacy

In the third century after its publication *The Wealth of Nations* holds its place as the most cited work in economics. As we shall see, the economic and political crises of the early twentieth century led to a loss of faith in the effectiveness of the free market. John Maynard Keynes and others argued that the economy required greater levels of state involvement (see chapter 2), and for a short time communist economic systems appeared to be viable alternatives. However, as we shall see, the economic crises and inflation in the West during the 1970s and the disintegration of communism in the late 1980s led to the discrediting of Keynesian macro-economic management and the utter abandonment of socialist state planning. In the strong revival of the belief in the superiority of the free market as the means of organizing economic activity, Smith's analysis of the efficacy of the market experienced a strong revival. Together with the work of later theorists such as Friedrich Hayek (1899–1992) and Milton Friedman (1912–2006),[6] *The Wealth of Nations* forms the basis for the hegemony of today's economic 'neo-liberalism', which favours market deregulation, privatization and the reduction of the state's role in economic affairs.

Pro-globalization arguments for the extension of market capitalism are fundamentally Smithian in their advocacy of a world-wide division of labour and free trade, with states largely restricted to the provision of public goods and the facilitation of the market mechanism (Wolf 2005). Even his greatest critic, Karl Marx, agreed that the division of labour, competition and trade were responsible for the hitherto unprecedented expansion of human welfare; but he believed that Smith had misunderstood the nature of the 'invisible hand' and its eventual consequences. For Marx, the capitalist system was to be explained not simply by the technologically determined division of labour and market exchange, but, rather, by the inherent inequality of power of capitalist property relations. Furthermore, the market's efficiency was ultimately negated by contradictory and eventually destructive tendencies.

Karl Marx (1818–1883): exploitation and the fatal contradictions of the capitalist mode of production

As Lenin observed, Marx combined three strands of thought – German philosophy, French socialism and Scottish and English political economy (Kolakowski 1978). Our main focus will be on Marx's critical dissection of the last-mentioned, for which he used two related analytical tools taken from German philosophy: the distinction between appearance and essence, and the Hegelian idea of historical progress through the dialectical interaction of contradictory elements. First, Marx sought the 'laws of motion of modern society' at a deeper level than the superficial appearance of, on the one hand, equal exchange between freely contracting individuals and, on the other, the functional integration of the factors of production in the 'circular flow'. He also challenged the idea that capitalist society harmonized individual interests and collective social welfare in the way that Adam Smith had contended.

For Marx, capitalist production did not have the primary aim of creating 'use-values' for the satisfaction of genuine human needs; rather it was an economic system exclusively oriented to the realization of monetary profit by the production of commodities with an 'exchange value'. In Smith's scheme these two goals are reconciled by the invisible hand; but, for Marx, the capitalist mode of production places them in opposition. Use-values are subordinated to the pursuit of exchange-value and profits. Moreover, the seemingly free market of exchange between legal equals masks an underlying reality of increasing inequality and exploitation. Workers, unlike slaves, were free to choose which master to work for, but, without alternative means of subsistence, they were compelled to sell their labour to the bourgeois class. The fundamental market exchange in capitalism – that is, the buying and selling of labour power – was inherently unequal. Marx sought to tear away what he considered to be the 'masks' and 'veils' that bourgeois political economy had placed over the real 'laws of motion' – that is, to uncover the *essence* that lay beneath the superficial *appearance* described in what he referred to as Smith's 'bourgeois political economy'.

Second, the idea of a harmonious integration of the factors of production – land, capital and labour – was unable to explain obvious features of capitalist society. If capital, production, income and consumption were functionally linked in a 'circular flow' of equal exchange, in which the revenues from each were used by the others to the point where costs were covered, how were profits and economic crises to be explained? A 'circular flow' guided by an 'invisible hand' seriously misrepresented a type of society that was subject to ever more frequent economic booms and slumps and growing inequality. Marx contended that the pursuit of individual interest in the market not only failed to maximize collective welfare but also resulted in the anarchy of uncoordinated economic decision-making that brought about unintended and uncontrolled fluctuations between over- and under-production.

In general, Marx argued that crises were expressions of the inherent contradictions between the elements that comprised the different modes of production in the development of human society – that is, the *forces and relations of production* (see below). Furthermore, these contradictions and crises were the driving force of history. Smith's circular flow was a static model of an equilibrium that could not explain how the historical stages in Smith's scheme developed one from the other. In Marx's theory, the inherent crises were resolved by the dialectical progression to a new mode of production which, in turn, developed its own contradictions. Society moved from primitive communism to the classical mode of production of the ancient world and thence to feudalism, followed by the intensification of contradictions in the capitalist mode of production which would lead to its collapse. Capitalism's basic institution of private property would be abolished and be replaced by a socialist system in which democratically controlled production would be devoted to the satisfaction of human needs rather than the pursuit of profit.

We can approach Marx's exposition of the 'laws of motion' of the capitalist mode of production in a little more detail, by looking at his fundamental distinctions between these basic concepts of his system of thought: *use-value* and *exchange-value*, *labour* and *labour power*, and *forces* and *relations* of production and their *contradictions*.

Use-value and exchange-value

At the beginning of volume I of *Capital*, Marx observes, as Smith and others had done, that all useful objects may be considered both qualitatively and quantitatively (Marx 1976 [1867]: part one, chapter 1). On the one hand, they possess qualities and properties that make them useful (*use-value*), and, on the other, the amount of labour that has gone into their production makes it possible to measure their value in relation to other commodities (*exchange-value*). In a departure from what he referred to as the bourgeois political economy of Adam Smith and others, Marx argues that a useful object becomes a *commodity* only in a social system that organizes production for exchange on the market with the primary aim of monetary gain. Of course, commodities are useful, but what is produced and in what quantity is not in the first instance driven, in the capitalist mode of production, by considerations of utility. Marx summarizes his argument by contrasting two forms of exchange – Commodity-Money-Commodity$_1$ (C-M-C$_1$) and Money-Commodity-Money$_1$ (M-C-M$_1$). In C-M-C$_1$, objects are produced and sold in order to obtain the money that will enable the producer to gain the satisfaction of other utilities. Bourgeois political economy assumes that this form of exchange is universal. But Marx argues that it masks the underlying reality of a particular capitalist M-C-M$_1$ form of exchange in which commodities are produced with the primary goal of realizing more money.

Marx argued that the distinctions between use and exchange value and the two different circuits of exchange uncover two distinctive and inherent features of the capitalist mode of production: first, that labour is transformed into the commodity 'labour power' and, second, that recurrent crises of over-production result from the production of commodities for their monetary exchange value rather than their utility.

Labour and labour power

Labour has use-value that is embodied in its products; for example, concrete labour is used to raise cabbages for sale in order to obtain money to purchase eggs (cabbages-money-eggs; that is, C-M-C$_1$). But in the capitalist mode of production this concrete labour becomes abstracted as labour *power* – that is, a general productive capability that can be sold for a fixed period of time (money buys commodified labour power in order to realize monetary profit; that is, M-C-M$_1$). In capitalism, a worker *appears* to sell a precisely fixed quantity of concrete labour, but actually sells the creative potential labour power that can be manipulated by the capitalist to extract surplus value (Marx 1976 [1867]: part one, chapter 2). This distinction is explicable only in terms of capitalism's social relations of production in which members of the social class of property-less wage-labour are objectively constrained in the absence of alternative means of subsistence to sell their productive potential to property-owning capitalists. Unlike the property-owing peasant who performs concrete labour in order to produce to engage in market exchange (C-M-C_1), the property-less wage-labourer can survive only by selling abstract labour power. This is the key to the deciphering of the mystery of the existence of profit in an apparently equal exchange between capital and labour that masks the underlying reality of exploitation.

According to Marx's labour theory of value, the value of labour power is determined like another commodity by the amount of concrete labour time needed for its reproduction. That is to say, the value of labour power is equal to the value of the other commodities – food, clothing and so on – needed to maintain the worker's family. But, in capitalism, the worker submits to the power of capital in a regime and a length of working day that uses the abstracted labour power to create exchange values greater than that necessary for the reproduction of the labourer and family. This *surplus value* represents the 'unpaid' labour power that is appropriated by the capitalist (Marx 1976 [1867]: part three, chapter 9). Smith saw this as the profit that represents the exchange-value of capital to the process of production; but Marx argued that this obscures the *exploitation* that is inherent in operation of the capital–labour relation.

The forces and relations of production and their contradictions

All historical modes of production – primitive communism, ancient slavery in Greece and Rome, feudalism and capitalism – comprise *material forces* and *social relations* (Marx and Engels 1968 [1859]: 180–4). The *material forces* are the means of production, such as machine technology, and also sources of energy, raw materials, land, skills and knowledge.

The *social relations* refer to the different historical patterns of ownership, control and organization of the material forces. In ancient slavery for example, all human and non-human material means and forces of production are owned by the ruling class. In feudalism, serfs are bound to the ruling class's land, but they are left in control of the process of agricultural production which is expropriated by the ruling class after the harvest. Capitalism is distinctive in so far as workers are legally free, but are none the less exploited.

Smith identified 'capital' with the material forces of production – tools and machinery, but Marx argued that these material means only become 'capital' in a system where they are appropriated by one class and operated by another. That is to say, *social relations* refer to the property relations which govern the organization of production. In Marx's view, Smith's focus on the material or technological 'factors of production' ideologically masks these relations of power between the classes by which labour power is transformed into surplus value. Bourgeois political economy presents the capitalist system as an objective, or natural, state of affairs which is determined by the characteristics of the material forces and means. However, capitalism, for Marx, is specified by its social relations rather than its technology. With the abolition of private property and the introduction of socialist social relations of production, these material forces could be put to work to provide for human needs, not simply to generate profits.

In Smith's scheme, landlords, capitalists and labour receive their respective revenues in rents, profits and wages as a consequence of the productivity of the material factors that they represent. Landlords with fertile land will receive higher rents; capitalists with more productive machinery will make more profits; and workers with scarce skills will receive higher wages. However, this did not explain why a consistently greater share went to rents and profits. Marx's explanation begins with the assertion that rent, profits and wages are not natural phenomena; rather, they are social categories that can only be understood in terms of the social relations of production, based on power and compulsion. Rents, profits and wages did not, in the first instance, express the relative functional contributions of the factors to the total social product.[7]

Rent, for example, did not simply express the productivity of the land, but was essentially a social category that was only intelligible in terms of the unequal property relation between landlord and tenant. Similarly, the profits of capital could only be realized if the means of production were appropriated by one class and operated by property-less wage earners. Capital did not comprise 'things'; rather, it was a social relation. The 'spinning jenny' of the early Lancashire cotton industry was a machine that only became capital by virtue of its ownership by one class and operation by another.

Moreover, if labour is the ultimate source of value, as Smith contended, then capital must comprise expended labour. Capital that *appears* in the form of the material means of production is, *in essence*, alienated and appropriated labour. Capital is not merely a material factor of production, but is actually constituted by the surplus value that is a result of the inequality of the social relations of production between owners and non-owners.

The capital–wage relation and the proletariat were the historical product of, among other things, the Enclosure Acts in England that dispossessed the peasants, who were consequently compelled to sell their only possession – labour power – and become the proletariat. For Marx, the state not only created, by design and default, the social relations of production, but was constantly required to maintain the inequality of power on which they were based. It was the 'executive committee of the whole bourgeoisie' whose competitive economic struggle often prevented them from seeing, and more frequently from acting in, their best general interest (Marx and Engels 1968 [1848]). For example, the British state intervened during the nineteenth century to shorten the working day, not simply as a result of workers' agitation but also to prevent the capitalists from weakening and demoralizing their most valuable asset – the actual creators of surplus value. In his early critique of Hegel's philosophy of the state, Marx formed the view that the extent of its role was in direct proportion to the severity of capitalism's contractions and crises. Far from playing the minimal role advocated by Smith, the state would become increasingly involved in the futile tasks of controlling class conflict and trying to resolve the economic crises (see the discussion of the capitalist state in chapter 8).

Marx's model of the evolution of modes of production was based on the Hegelian idea of dialectical progression. Applied to social and economic formations this meant that the basic elements of forces and social relations of production were bound together in a simultaneously positive and negative manner – that is to say, in a set of contradictions. For example, Marx agreed with Smith that competition between capitalists accounted for dynamic economic progress, in which the bourgeoisie had played their own revolutionary and necessary role in developing the forces of production. But, Marx contended, this competition resulted in an anarchical drive to produce commodities with exchange-value which led to periods of overproduction, followed by recessions, as capitalists tried to cut their losses by reducing output.

The most important expression of the contradiction between forces and relations was the falling rate of profit, which Marx believed gave his critique of capitalism an objective or scientific basis. That is to say, the bourgeoisie were powerless to prevent the normal functioning of capitalism from undermining the very thing that it was organized to achieve – profits. He divided capital into 'constant' capital (raw materials and machinery) and 'variable' capital (the amount spent on wages). 'Variable capital' is, in fact, 'labour power', which, in Marx's scheme, is the only source of surplus value and profits. In their intense competition the capitalists are pushed to increase the productivity of labour by constantly improving the technological means of production – that is to say, by substituting 'constant' capital for 'variable' capital. This is the bourgeoisie's progressive historic role – to make the means of production more efficient; but in performing it, they are compelled to substitute 'constant' for 'variable' capital and, consequently, become their own 'gravediggers' (Marx and Engels 1968 [1848]).

As 'variable' capital is the only source of surplus value, its replacement by the non-surplus producing constant capital causes a fall in the *rate* of profit (Marx 1976 [1867]: part three, chapter 9). This need not be a fall in *total* profits, as total output may grow; but the fall in the *rate* of profit has the effect of driving the capitalists to attempt to extract more surplus value by, according to this analysis, the only means possible – that is, lengthening the working day and increasing output. In turn, this not only further demoralizes, debilitates and antagonizes the workers, but also, as a consequence of the prior increase in constant capital (machinery) and subsequent increase in labour productivity, creates further overproduction. The cyclical crises continue to deepen as the bourgeoisie seek ever increasing levels of surplus value and, therefore, create further capital and production that the system cannot absorb. Although Marx's analysis of the falling rate of profit has been largely rejected, the assertions that capitalism inevitably produces class conflict and cycles of overproduction followed by recession commands greater acceptance (for an application of the falling rate of profit analysis to the economic crises of the 1970s, see Brenner 2002). As we shall see, for example, Keynes sought a remedy for capitalism's inability to maintain high levels of output and employment.

As we suggested above, for Marx the possibility of socialism rests on this distinction between the forces and relations of production and their contradictions. Capitalist social relations, not the means and forces of production, cause the crises. The forces were an expression of humanity's creative powers – that is, human labour in the most general sense. But these potentially limitless forces were stunted by the capitalist social relations of production. With their removal, and consequently the compulsion to realize surplus value, workers would no longer be compelled to sell their labour as the 'commodity' of 'labour power' with an 'exchange-value'. Labour would regain its true nature as a 'use-value', which could then be devoted to the production of other use-values and the satisfaction of wants freely and cooperatively established in the true democracy of socialism (on Marx's concept of 'true' democracy, see Avineri 1968). Socialism would make the 'machinofacture', developed by the bourgeoisie, more effective and able to free humanity from necessity by its unbounded productive capacity.

Is Marx's Capital *relevant today?*

Libraries are filled with over a century of compelling critiques of Marx's analysis of the capitalist mode of production and his confidence that the contradictions would lead to its collapse. And, despite the constant fear of global economic instability, there is no sign of the apocalypse that he envisaged. Indeed, as we shall see in part II, it is widely believed that modern capitalism is able to resolve its crises more quickly than before and that economies have not experienced such protracted periods of deep depression as they did before the Second World War. Moreover, since the collapse of almost all of the totalitarian communist regimes, which falsely claimed to have enacted his hopes for the future of humanity, Marx has fallen out of favour and capitalism endures and spreads across the world.

However, it would be a mistake to dismiss the general thrust of Marx's analysis (for example, see Wolff 2002; Callinicos 2003). In the first place, it is premature to think that the expert management of economies is able to eliminate serious dislocation, or even moderate the severity of the oscillations between boom and slump in the 'business cycle'. As we shall see in part II, such optimism was shaken twice in the late twentieth century – first, by the collapse in the 1970s of the post-Second World War so-called Keynesian 'golden age' and, second, at the turn of the twenty-first century, by the crash of the 'new economy'. Towards the end of the 1990s it was widely believed that the astonishing advances in information and communication technology would increase productivity to such an extent that economic fluctuations and recessions would be consigned to history. From a Marxian perspective, it would have been understood that in analysing capitalism attention should be paid not merely to such 'forces' of production, but also to the 'social' relations from which the dislocations and malfunctioning arise.

Overt class conflict might appear to have abated in the advanced economies during the very recent past, but this does not signify its elimination. During the post-Second World War period the 'withering away' of the strike was announced by those who did not hold to the Marxian idea of inherent capital–labour conflict (see chapters 4 and 8). However, an explosion of militant trade unionism followed. In Britain, for example, the Conservative government's project in the 1980s to reduce the power of trade unions is unintelligible without the notion of class conflict. And, of course, the conflict continues to be played out in the world's developing economies in ways more reminiscent of earlier days in western Europe and the USA. In short, the question is what has happened to the struggle between labour and capital? Has it been genuinely overcome by economic development and affluence, or is labour's opposition suppressed and stifled in advanced capitalism? These questions will be taken up in later discussions.

However, Marx's understanding of capitalism's instability is marked by an underestimation of the role played by money in the crises. Marx correctly identified the capitalist mode of production's distinctive Money-Commodity-Money$_1$ (M-C-M$_1$) circuit. But, in common with Adam Smith and most nineteenth-century economic thinkers, Marx was less clear about the way in which capitalism is uniquely characterized by a banking system that can create an unlimited amount of credit-money that fuels the crises either through the financing of overproduction and/or speculation.[8]

As we shall see in chapter 2, Joseph Schumpeter was one of the first to recognize that the *differentia specifica* of capitalism lay in its credit-money-producing banking system. Later John Maynard Keynes referred to capitalism as a 'monetary production economy' and focused on the role of credit-money creation. The nature of capitalist banking and finance is also an important, but neglected, theme in Max Weber's work (Ingham 2003). However, here I wish to focus on the synthesis, implicit in Weber's conception of capitalism, between the nineteenth-century economic theorists' emphasis on the market's efficacy and Marx's insistence that it was founded on inequalities of wealth and power.

Max Weber (1864–1920) and the historical specificity of capitalism: rationality, calculation and domination

Weber tried unsuccessfully to halt the academic specialization in the historical and social sciences that he believed had impaired the understanding of the development of modern capitalism. His original synthesis drew together, but at the same time transcended, economic theory, Marxism and histories of Europe's cultural uniqueness. Whilst he agreed with economic theory that the pursuit of self-interest was universal, he argued that this in itself was unable to explain the rise of the very distinctive kind of 'rational' enterprise capitalism that had first appeared in western Europe. The oriental trader's desire for profit was unsurpassed anywhere in the world (Weber 1981 [1927]: 355), but the economy of which he was a part remained traditional and backward. Here, production was organized domestically or communally and was undertaken, as Marx and others had explained, for direct use rather than exchange on the market. The market occupied a marginal position in pre-capitalist economies, and acquisitiveness was not the major economic motivation.

For Weber, the unique characteristic of modern European capitalism was not merely that acquisitive profit-seeking had permeated economic life. Rather, he focused on the distinctive way in which profit was pursued. Capitalism is defined as the satisfaction of human needs and wants by industrial production undertaken by bureaucratic enterprises in which net profit is rationally calculated (Weber 1981 [1927]: chapter XXII). Continuous calculation of the income-yielding activity by capital accounting is the essential element in this type of economy, and Weber's explanation of the structure and development of capitalism takes the form of an analysis of the conditions which make this possible.

In an immediate and direct way, this 'maximum formal rationality of capital accounting' was achieved by the invention of double-entry bookkeeping, in which a balance is struck between revenue and costs (Weber 1978: 164–6). But such techniques are only likely to develop in a society where they can be applied. And rational economic calculation is only possible where social reality exhibits a significant degree of predictability – that is, one in which the processes of economic production and distribution have become 'calculable'. In this respect, for example, the autonomy of the business enterprise is centrally important. The separation of work and production from the domestic household and community eradicated substantive and arbitrary considerations – grounded in emotional ties, family obligations and traditional social norms – that might interfere with strict economic rationality in the calculation and pursuit of profit.

How the world had come to be a range of options for the calculation of profitable opportunities required an explanation. Weber sought this in the history and social structure of early modern western Europe, which he contrasted with that of the Orient. This thesis, that the rise of modern rational capitalism was historically specific and unique to Western society, has been extensively criticized for being 'Eurocentric' (see Frank 1998). The question cannot be considered here, but the questions raised by Weber continue to have contemporary relevance – for example, in the debate about the compatibility of Islam with capitalism.

The ideal type of modern capitalism

In his *General Economic History* Weber lists those institutional features of Western society that enable rational capital accounting in the enterprise (Weber 1981 [1927]: 276–8; 1978: 161–4). To repeat: it is these changes in west European social structure that make it possible for the enterprise to calculate net profit. In other words, capitalist economic practice is not merely the consequence of *Homo economicus*'s capacity for rational calculation, as it is in economic theory.

1. The appropriation of all physical means of production as the disposable property of private autonomous enterprises. This was a unique development in human history and permitted the flexible switching of production in the search for maximum net income. Physical capital can be disposed of for money which can be reinvested in alternative ventures. As I have indicated, arbitrary and non-rational intrusions into the conduct of the enterprise's affairs are minimized if the household or family budget is separated from the enterprise budget.

2. The absence of customary limitations on market exchange in goods and labour, that is, free commodity and labour markets. For example, mediaeval European sumptuary laws restricted consumption according to status group, and certain

classes were prohibited from owning property and following specified occupations. The Indian caste system is one of the clearest examples of such restrictions on market exchange. With Marx, Weber viewed the market as the site of the 'battle of man against man' 'to attain control over opportunities and advantages' (Weber 1978: 93, 38). Market prices were the result of these struggles between the possessors of money, capital and other economic resources. Economic 'scarcity' could only be established by 'conflicts of interests in bargaining and competition and the resolution of these conflicts' (Weber 1978: 92).

And this kind of conflict, which was the basis for the rational economic calculation of money prices, was more easily accomplished when the struggle was freed from arbitrary constraints and regulation as occurred in traditional society (Weber 1978: 82–5).[9]

3. Rational capital accounting presupposes a level of technological mechanization that is capable of producing a calculable output. For example, steam-powered machines are not merely faster, but also more predictable than wind, water and, most importantly, recalcitrant human labour power.

4. With calculable – that is, predictable – law, enterprises are able to depend on calculable adjudication and administration and freedom from arbitrary interference by the state. This condition was not fulfilled until the Stuart dynasty's claim to absolute monarchy in England during the seventeenth century and its appropriation of business opportunities had been successfully challenged. Today, this point is very clearly illustrated by the disquiet shown by US and European capitalist interests at President Vladimir Putin's appropriation of Russia's energy industry for geopolitical ends and his imprisonment of the prominent capitalist Mikhail Khodorkovsky.

Weber would have identified this as 'political capitalism', in which the state attempts to monopolize profitable opportunities in order to increase its political power. But he considered this subordination of the continuous calculation of profit-making to the interests of the state to be 'irrational from an economic point of view' (Weber 1978: 166) (see the discussion of 'rent-seeking' in chapter 8). To this extent Weber is in agreement with Smith and the liberal economists' critique of states' 'mercantilist' economic policies.[10]

5. Without formally free labour, rational capitalistic calculation is impossible. But the determination of the wage-costs of production, by agreement in advance, is only possible when people are compelled, 'under the whip of hunger', to sell their labour. In a further departure from economic theory Weber argued that the rational calculation of opportunities for profit required a power inequality in the enterprise. Capitalists are able to calculate labour costs with precision because, unlike slave-owners, they can control costs by dispensing with workers if demand for their production falls. As we shall see, the right of capitalists to lay off workers has become one of the most contentious issues in modern capitalism. Thus Weber was in close accord with Marx that power and exploitation were necessary for the operation of capitalism, but he flatly rejected the latter's diagnosis of capitalism's demise and his prognosis for humanity's future.

6. The commercialization of economic life means that all share rights in the enterprise and other forms of property and assets are represented by marketable paper instruments. This last condition is elaborated in two short consecutive chapters in *General Economic History* which place more emphasis on the financial character of capitalism (Weber 1981 [1927]: chapters XXIII and XXIV). The existence of extensive markets in which property and capital are represented by freely negotiable (marketable) paper is unique to the Western world and heralds the appearance of capitalism's great speculative crises. Prices of paper instruments representing property and capital are driven up by demand stimulated by expectations of further rises in price. A point is reached where a loss of confidence turns the market and mass selling brings about a precipitous fall in price. Financial crises were entirely new phenomena, as was the possibility of over-speculation in the supply of means of production beyond the economy's capacity for consumption, as Marx had explained. Both were made possible by the availability of finance in the form of bank credit; and

both types of crisis brought bankruptcy and the consequent disruption of production in a process which later became recognized as 'debt deflation' (see Minsky pp. 40–2; and chapter 7).

Weber devoted relatively little attention to money and banking, but he did see that the creation and circulation of bank credit in western Europe was an important and unique development (Weber 1981 [1927]: 255). He was aware that Western capitalist banks did not merely accumulate existing savings in deposits for lending on, but also that they had the power to create 'new' deposits of money in the form of bank loans. As we shall see, the process by which personal credit becomes money is a core institutional element of capitalism. Loans to individuals are private debts to banks and are transformed into public money by the banking system's linkage with the central bank and the state's debts (see Ingham 2004, chapter 7; see the discussion of Schumpeter and Keynes in chapter 2 below).

In addition to the explanation of *how* it was possible for the enterprise rationally to calculate and devise strategies for maximizing net income, Weber also posed the question of *why* they should do so (Weber 1981 [1927]: 354). The orientation to work and profit-seeking was quite different in Western capitalism from that in traditional societies. Economic maximizing behaviour of the kind described by the economists' model of *Homo economicus* was historically atypical. For example, in his early study of Silesian peasants, Weber observed what economists now refer to as a 'backward sloping supply curve' for labour. This describes the situation in which workers cease to respond to economic incentives once they have attained a level of income that provides for their traditionally limited pattern of consumption. Further inducements to elicit more work by linking pay to output are ineffective, as workers respond by producing no more than the level that achieves the income that satisfies their traditional wants (Weber 1982 [1927]: 355). Without the erosion of such traditional attitudes, the stimulation and satisfaction of new wants by industrial production would not have been possible.

Weber applied the same observation to his explanation of early entrepreneurs' motivation for the continuous calculation and pursuit of profits as an end itself rather than a means to other extrinsic goals. In a traditional society, making profits to reinvest in order merely to make further profits was an example of 'non-rational' action in which 'means' had become 'ends'. When competitive capitalist markets had become fully established, the relentless search for profits to be ploughed back into the enterprise was an externally imposed exigency. Failure to behave in this way could mean being forced out of business by more efficient competitors. But such pressures were very weak, if not entirely absent, in the early stages of capitalist development. In these circumstances, why did the first entrepreneurs appear to strive for profit as an end in itself?

Weber's answer is contained in his best-known work – *The Protestant Ethic and the Spirit of Capitalism* (2001 [1904]). Here, he attempted to show that there was an affinity between certain beliefs in Protestant theology and unremitting capitalistic profit-seeking. Unlike the hedonism of traditional elites, the Puritan's asceticism facilitated the reinvestment of profits and the expansion of enterprise which could be interpreted as the glorification of God on earth. The good husbandry of the gifts that God had bestowed might even be considered to be a 'calling'. In addition, Weber advanced the view that Protestant theology played an important part in expunging the superstition, magic and supernatural beliefs that he saw as inimical to the instrumentally rational manipulation of nature by means of industrial technology. In contrast, the oriental religious ethics contained in Hinduism and Buddhism reinforced the traditionalism and irrational beliefs that inhibited the development of a rational economic spirit.

However, in the mature capitalism of the early twentieth century, Weber observed that '[t]he religious root of modern economic humanity is dead; today the concept of calling is *caput mortem* in the world' (Weber 1981 [1927]: 368). By this stage he seems to agree with Marx that religion is more important as an ideology that pacifies workers by promising happiness in the next world in compensation for the rigours of life under the capitalist regime (Collins 1986).

In a further departure from economic theory, Weber argued that these essential elements of modern capitalism were not simply the spontaneous result of a natural predisposition to barter and exchange – as Smith had contended. On the contrary, it was the actions – intended and unintended – of the early modern European states that had brought about the conditions favourable to rational capitalism.

The development of capitalism in the West

The emergence of the social and political conditions that made possible industrial production on a large scale, conducted and organized by rational capital accounting, grew out of the destruction of traditional obstacles to domestic free trade in land, capital and labour, and by the creation of mass markets for industrial production on a large scale. Weber attributed these developments to the intended and unintended consequences of the development of the modern European state. Adam Smith acknowledged the state's role in the operation of markets; and Marx, of course, emphasized the coercive power of the state in creating and subsequently suppressing the class of wage-labour. But, characteristically, Weber went beyond these two views of the state as, respectively, facilitator and oppressor. His analysis remains of considerable importance for today's debates on the changing relationship between states and markets brought about by 'globalization' (see chapter 8).

In a direct way, the modern European state, based on rational-legal principles administered by professional lawyers, removed feudal and patrimonial relations, and thereby created the social and political space in which capitalist property relations and markets could develop. But Weber also considered the wider economic consequences of the political relations between modern states and their members and between the states themselves.

Most importantly, the members of modern European states became citizens with equal legal rights that provided a basis for formally equal contractual economic exchange and representative democracy. These institutional links between capitalism, liberalism and democracy will be considered in chapter 8; here I wish to draw attention to further economic implications of the state–citizen relation in modern Europe as noted by Weber. In superseding social relations based on kinship, tribe and status group, citizenship eroded ritualized communal exchange and the 'ethical dualism' in the exchange relations of traditional society (Weber 1981 [1927]: 313, 359). On the one hand, exchange within communities was normatively regulated by rules of fairness and an ethic of charity which minimized internal conflicts. For example, the prohibition on usury was aimed at avoiding the exploitation and the disruptive calculation of gain at the expense of other members of the community. Moneylending in traditional societies, Weber observed, was carried out by outsiders – Jews in Christian Europe, Christians in the Islamic world, and Parsees in India (Weber 1981 [1927]: 232). On the other hand, outsiders were cheated and exploited. Both sides of the dualism inhibited the formation of large markets – that is, of economic transactions based on impersonal trust between strangers.

Furthermore, in contrast to members of traditional, rigidly stratified societies, a mass citizenry of equal legal status can more readily become mass consumers of undifferentiated mass products. Perhaps it is by no means coincidental that the USA, in which status group consumption differences were relatively attenuated from its inception, was the first mass consumption society. Moreover, as Weber astutely observed, mass production technology is only cost-efficient if mass consumer demand exists. Of course, this can be created by marketing and advertising, but this would appear to have been more easily accomplished in some societies than others.

A strong bureaucratic state was a necessary, but not sufficient, condition for the development of rational capitalism. Only under certain historical conditions in which the state was faced with the countervailing power of an independent economic bourgeois class did rational capitalism develop. It was the largely unintended outcome of the resolution of the struggle between state and capitalist classes in a 'memorable alliance'. This mutual accommodation of state and bourgeoisie created the means to meet the fiscal needs of states when financing the wars by which the European state system was consolidated (Weber 1981 [1927]: 280). This was most clearly seen England, where the successful founding of the Bank of England in 1694 to finance the conduct of war by the king furthered the interests of both the state and the mercantile classes and had a pivotal effect on the development of capitalism (Weber 1981 [1927]: 264–6; Ingham 2004). As we shall see in chapter 4, fiscal systems based on 'public' banks and state borrowing, with interest payments on loans provided by taxation, were the means by which the credit-money and money markets financed capitalist development. Moreover, this financial relationship between the state and the bourgeoisie was not only a domestic affair; states had to compete on international markets for the mobile capital produced and controlled by the independent cosmopolitan merchant class and their new banks.

In capitalism, according to Weber, the dominant economic classes do not simply control the state, as cruder Marxist theories imply. They depend on the state's autonomous power, but they are not subordinated to it. The 'memorable alliance' is loose enough to allow capitalist classes to operate freely both within and between states. From the beginning, capitalism was an economic system which operated transnationally in a way that was beyond the control of any single state or alliance of states. By and large, capitalists are not in principle restricted in their freedom to seek profits, wherever this might take them. The state, Weber concluded, gave capitalism its opportunity for development; and he added the rather cryptic, but brilliant, insight that 'as long as the national state does not give place to a world empire capitalism will also endure' (Weber 1981 [1927]: 337). In other words, Weber believed that capitalism would flourish as a global economic system in which neither the state nor capital subordinates the other. Capitalism would not collapse under the weight of its economic contradictions, as Marx predicted. Rather, it involves a perpetual political conflict between states and an increasingly cosmopolitan bourgeoisie in which the balance of power swings from one to the other. The subordination of capitalists to the interests of the state would destroy the dynamism of the system; but the converse subordination of the state to the interests of capitalists would lead to excessive, debilitating exploitation and political turmoil. As we have noted, Weber's enduring relevance could not be more clearly seen than in today's struggle between President Putin and the Russian capitalist oligarchs. Their 'memorable alliance' has yet to be forged, but a Weberian perspective would suggest that without one Russia is unlikely to make a successful transition to capitalism. The case of China poses even more intriguing questions concerning the relationship between state and capitalist power (see Nolan 2004; Hutton 2007).

Weber's analysis remains the single most comprehensive account of the social structure of capitalism (see also Collins 1986). It replaced the timeless universals of economic theory's *Homo economicus* and the more narrowly materialist focus of Marx and his followers. Weber identified the specific historical elements of the unique form of economy that was based on the continuous calculation of opportunities for profit and was first developed in early modern western Europe. This had two basic foundations. On the one hand, the rational legal state and modern bureaucratic organization made possible, respectively, the removal of non-rational substantive prohibitions on market exchange and the reduction of arbitrariness in the conduct of human affairs. Both the modern state and the modern enterprise were bureaucratic, rule-governed and, in principle, calculable. Markets and bureaucracies are complementary and not opposed institutions, as cruder forms of economic analysis and ideology maintain.

On the other hand, in the absence of state or private monopolies, power struggles, conducted and regulated according to the 'rules of the game' enforced by the state, between opposed economic interests produce a level of predictability that makes it possible to express relative scarcity in money prices. Prices are the outcome of an economic power struggle; for example, rising price inflation expresses changes in the balance of power. The market is the means by which opportunities for profit can be calculated, as it is in economic theory, but, for Weber, it is the site of the 'struggle for economic existence' and the location of conflicts that are much more extensive than Marx's two-class model of capitalists and workers. To this Weber added lenders versus borrowers and sellers versus consumers and so on. He also emphasized that the various economic classes strove to monopolize any advantages of their market situation rather than overthrow the system. Thus capitalism involves the tension between the dynamism that the free market makes possible and the efforts of the participants to extend and preserve any advantage that they can carve out (Collins 1986: 126, 258).

Finally, as I have suggested, Weber's conception of capitalism contains the germs of an approach which recognizes the importance of distinctive forms of credit-money and public banking that appeared in early modern Europe – first in the Italian city states, followed by Holland and England (Weber 1981 [1927]: chapter XX; Ingham 2003). This was taken up by his one-time collaborator Joseph Schumpeter, as we shall see in the following chapter.

Conclusion

Marx and Weber cannot be fully understood without taking into account their opposition to economic theory's understanding of market capitalism and its origins in the work of Adam Smith and the other classical economists. The commonalities of their critiques are, arguably, more significant than the differences which have surely been overdrawn and exaggerated by generations of sociologists (see Collins 1986; Ingham 2003).

To be sure, Weber utterly rejected the implicit economic determinism in Marx's vision of capitalism's collapse. But he presciently argued that if socialism were to be brought about, by political revolution, in a large, complex, industrial society, then it would require a bureaucratic administration that might be more oppressive for the workers than capitalism. Moreover, such a regime would risk losing the dynamism that was produced by the general 'struggle for economic existence'.

However, in contrast to orthodox economic theory, both theorists understood capitalism as a distinctive historical social system that was based on institutionalized inequalities of power. Weber fully accepted Marx's emphasis on the central importance of the complete expropriation of the means of production as the property of the capitalist enterprise and, in the absence of alternative means of subsistence, the fact that workers were compelled to sell their labour power.

2
Schumpeter and Keynes

Money in Adam Smith's scheme was considered to be no more than a neutral medium that facilitated exchange on the 'great wheel of circulation'. Capital was understood primarily in physical terms as 'stocks' – the instruments of production and raw materials. These were the 'real' factors of production and they were not to be confused with the mere 'wheel' – that is, the money by which they were circulated (Smith 1986 [1776]: 385).[1] Similarly, Marx sharply distinguished money-capital and credit from the means of production, and frequently referred to the former as 'fictitious' capital. But as the capitalist system developed during the nineteenth century, its distinctive monetary and financial character became clearer and these elements began to assume a more prominent place in the analyses of the economy. The idea began to take shape that money was more than a mere medium of exchange and a measure of the value of actual existing physical capital; rather the creation of credit-money was an autonomous force in capitalist development.

Joseph Schumpeter (1883–1950): money markets as the 'headquarters of capitalism'

Schumpeter crossed disciplinary boundaries as they were developing during the first half of the twentieth century, but not to the same extent and with the same conviction as Weber (see Schumpeter's magisterial posthumous *History of Economic Analysis*, 1994 [1954]). On the one hand Schumpeter was attracted to the mathematical sophistication of the equilibrium models of academic economics, but he also saw the importance of the historical study of economies and admired Marx's project and method, if not its details and conclusions. The result was ambivalence about the best way to study capitalism, but Schumpeter's seminal contribution is precisely the result of this tension. His work sought to resolve two related problems in the theoretical understanding of capitalism. First, Schumpeter concluded that Smith's 'circular-flow' model, which was the foundation of the equilibrium theories he admired, could not explain the definitive characteristics of capitalism that Marx had correctly identified – that is, the realization of monetary profits and the continued dynamic expansion of the means of production. Schumpeter's second criticism of economic theory was that the function accorded to money in its circular-flow model meant that it was unable to grasp the particular financial character of capitalism.

In classical economic theory no factor should receive more in income than its input, as measured precisely by costs, to the process of production. We saw earlier that revenues accruing to each factor of production, in Smith's model, are consumed in the subsequent sequential phases of the productive process. Supply and demand in the competitive market eventually ensure that no factor can receive more revenue than that which covers its costs. Schumpeter agreed with Marx's critique that this does not account for profits and any accumulation of surplus for investment (Schumpeter 1961 [1911]: 30–2). In short, capitalism's capacity for dynamic growth and constant revolutionary transformation of the means of production could not be explained by the static 'circular-flow' model.

These distinctive characteristics of capitalism are frequently explained in economic theory as the result of 'exogenous' factors such as technological invention. But what called forth the new techniques and ensured their application? It was difficult to see how the 'invisible hand' could do this without the assumption that it would be profitable for individuals to do so. But the 'circular-flow' model did not contain profits.

Nor did it contain a further distinctive element in capitalism that Weber had touched on – the creation of bank credit-money. In short, Schumpeter set out to resolve these inconsistencies and anomalies in Smith's model and to explain what capitalists actually did.

Profits and the role of the capitalist entrepreneur

The implication of Smith's and other economists' models of the circular flows of production, distribution and consumption in which the entrepreneur merely plays a passive role, responding to price signals in the market, is clearly at odds with the reality of capitalism's dynamism. On the contrary, Schumpeter argued, the entrepreneur is a key figure whose role is constantly to revolutionize the system by restructuring the factors of production in new ways that yield a profit for the initiator either by an increase in their productivity or by the production of new goods. In other words, the entrepreneur doesn't simply compete, but, rather, changes the nature of the competition (Schumpeter 1961 [1911]). Old industries and methods are swept away in a process of 'creative destruction'. In capitalism, however, this is only a temporary advantage, as others are free to adopt the innovations and enter the new sector. The ensuing competition drives down prices, as Smith's 'circular-flow' model predicts, and the subsequent falling profits lead to a 'destructive' phase.

Unlike Marx's vision of a cataclysmic collapse of capitalism, falling profits in the 'destructive' phase are not terminal for the system, as entrepreneurs continue to search creatively for profitable innovation. Schumpeter adds that this dynamic process is accelerated by the existence of a certain degree of monopoly which gives some protection in the initial costly and risky stages of innovation. That is to say, monopoly plays a positive role and is not necessarily as inefficient as it is in the model of the perfectly competitive market (see the discussion in chapter 5).

In addressing the supplementary, but essential, question of how entrepreneurial innovation was made possible, Schumpeter observed that the entrepreneur was the only economic agent in capitalism who was a debtor by the nature of his economic function (Schumpeter 1961 [1911]: 70–4). His analysis of the process by which capitalism was carried on with borrowed money involved a further departure from a 'circular-flow' model.

Capitalism and credit-money

Schumpeter located the rise of capitalism in the development of the law and practice of transferable debt and 'created' deposits in an emerging banking system during the sixteenth and seventeenth centuries, not in the nineteenth century's industrialism (Schumpeter 1994 [1954]: 78). (These monetary innovations are considered further in chapter 4; here we may simply note that transferable debt refers to the practice whereby a creditor is able to use their debtor's acknowledgement of debt – an IOU – as a means of payment to a third party.) The 'capitalist engine' could not be understood at all, Schumpeter contended, without reference to its credit operations and distinctive monetary system (Schumpeter 1994 [1954]: 318). The money markets were the 'headquarters' of capitalism (Schumpeter 1961 [1911]: 126); it was access to credit-money that drove the capitalist system.

At this time, most economic theory, and common sense, understood savings, finance and investment in a similar way to Smith's 'circular-flow' model. Here, as Schumpeter observed, banks are merely intermediaries between savers and borrowers, creating financial reservoirs by collecting together little pools of savings for lending on. But, as we have already noted, Schumpeter and others saw that capitalist banks produced new money by the act of lending, in the sense that the deposits that were created when money was advanced to a borrower were not taken from existing savings or matched by incoming deposits (Schumpeter 1994 [1954]: 319–20, 1113). Money was produced simply by the debt contract between banks and borrowers.[2] Schumpeter clearly grasped that the essential capitalist practice was the actual 'production' of bank credit-money out of nothing more than the promise of repayment (Schumpeter 1961 [1911]: 70–4).

The idea that money was capital had been roundly criticized by Smith and the classical economists as an error perpetrated by false mercantilist doctrines. As we have noted, capital was rather to be seen as 'stock' – tools, materials and other physical means of production. This was 'real' wealth; money was simply the means for exchanging it in the form of goods, or for representing their value symbolically. Additionally, in the era of precious-metal money, credit instruments – such bills of exchange and promissory and bank notes – were to be distinguished from 'real' money. Thus, although credit was important in facilitating trade and production it was not an autonomous force or factor of production, which could only be physical capital 'stocks'. Schumpeter moved towards a different view which gave a clearer account of the workings of the capitalist system. As we shall see in chapter 4, he favoured a credit theory of money – that is to say, all money, regardless of form and substance, is a token claim or credit. Moreover, he also considered that we would have avoided these 'downright silly controversies' about whether credit was money or whether money was capital if economists had kept to the Roman jurists' conception of capital as 'essentially monetary' (1994 [1954]: 322–3).

Schumpeter's efforts to resolve what he saw as the anomalies and inconsistencies of the 'circular-flow' model of the economy had led him, not without equivocation and uncertainty, to view capitalism as comprising two relatively autonomous parts – on the one hand, the material productive factors and, on the other, the monetary and financial. Unlike earlier economic systems in which money was based on the natural scarcity of precious metal, capitalism's banks and money markets had the capacity to expand money-capital without limit. This expansion of money was an independent source of dynamism, but it was also simultaneously the source of capitalism's crises. This was taken further by Schumpeter's pupil, Hyman Minsky, in his 'financial instability hypothesis'.

Minsky believed that 'as long as an economy is capitalist, it will be financially unstable' (Minsky 1982: 36). Following Schumpeter's observation that modern capitalism consisted of enterprise carried out with borrowed money, and echoing Weber in the importance he attached to capital accounting, Minsky observed that in a firm's balance sheet, comprising cash receipts and liabilities, 'the present, past, and future coexist in time' (Minsky 1982: 19). He identified three possible sets of relationships between incoming revenue and debt liabilities which describe progressive fragility: *hedge finance*, *speculative finance*, and *Ponzi finance*. In the hedge finance enterprise, anticipated total revenue exceeds running costs, and debt and interest payments are met within conventionally accepted accounting time periods. A speculative finance enterprise can only meet its debt and interest payments by selling assets or by further borrowing from banks and capital markets. Ponzi finance, named after the Boston swindler's pyramid scheme (for further discussion see Kindleberger and Aliber 2005: chapter 5), describes a situation in which current and projected earnings cannot meet payment commitments 'except for some end points of the horizon' (Minsky 1982: 22). Large infrastructural construction projects, such as the Channel Tunnel, often fall into this category, and Ponzi finance is typical of firms in the financial sector which borrow to acquire speculative financial assets for resale. Under most circumstances, as the cost of debt increases with time, profitability is only possible if the financial assets continue to appreciate. Consequently, Ponzi finance is especially vulnerable to changes in market conditions and interest rates. As we shall see in chapter 7, modern firms in the productive sector increasingly acquire financial assets in this way and in some instances, such as the notorious Enron case, come to resemble purely financial enterprises (see pp. 170–2).

Contrary to the widely accepted view that financial instability is the result of individual irrationality or miscalculation, Minsky argues that as capitalist enterprise is debt-financed, crises are 'normal functioning events' (Minsky 1982: 37). The typical cycle begins with the successful expansion of production and revenues of the prudent hedge finance enterprises. The growing cash balances in their bank accounts enables the extension of further loans by banks. In search of profit, these 'merchants of debt' make the loans to enterprises which fall into the 'speculative' and 'Ponzi finance' categories. As the level of unserviceable debt mounts, there is the increasing likelihood that the inability of an enterprise to meet its payments will initiate a chain reaction of defaults. Or, the monetary authorities, concerned by the rising level of debt, might try to curb credit-money creation by raising interest rates, which will also cause defaults that might trigger a chain reaction.

As current income of 'speculative' and 'Ponzi-financed' firms is insufficient to meet payments, assets are sold to realize cash, causing a collapse of asset prices which exacerbates the situation. As firms attempt to cut their losses by reducing output and laying off workers, output and demand fall, triggering a debt-induced deflation and possible depression ('debt-deflation').

For Minsky, the capitalist system is inherently unstable because of the ease with which its banking system can create credit-money, but he does not, however, draw a Marxist conclusion that capitalism will collapse as a result of these internal financial contradictions. Rather, he implies a paradox which we will explore further in chapter 7. As capitalist finance becomes more efficient in creating credit-money it becomes more vulnerable, but at the same time governments and their central banks believe that they have become more effective at monitoring the system and preventing this 'fragility' from becoming a 'crisis'. For example, as we have noted, credit-money creation can be controlled by raising interest rates, but this increases the probability of defaults. As the risk of default mounts, banks become reluctant to lend ('risk averse') which further accelerates the defaults and movement towards a recession in the economy, and investment and consumption slows in the wake of this credit 'squeeze', or 'crunch'. It is at this juncture that central banks intervene as 'lenders of last resort' by advancing loans to the banking system in order to prevent bank failures and defaults and the unravelling of the credit network and payments system. This also enables banks to advance loans to otherwise sound firms which had been threatened by non-payment of debts and falling prices. However, this action creates what is known as 'moral hazard' in which the banks, in pursuit of profits, continue to make imprudent loans in the knowledge that the central banks will not permit a collapse of the banking system.

It was arguably the most threatening of capitalism's debt-deflations after the Wall Street Crash of 1929 that prompted Keynes's seminal analysis of the capitalist system. Like Marx, he wanted to know why it produced such paradoxical and unintended effects. If human society was capable of producing such vast increases in productive power and wealth, why was it prone to unwanted crises and depressions?

John Maynard Keynes (1883–1946): making capitalism work better

The First World War, the Wall Street Crash in 1929, the final collapse of the gold standard in 1931, global economic depression and mounting unemployment in the 1930s combined to present, arguably, the most serious threat that the capitalist democracies have ever faced. But whilst the democracies floundered, fascist and communist authoritarian regimes had embarked on programmes of state-funded development which had increased employment. Keynes's fundamental aim was to solve the problem of depression and unemployment without sacrificing the economic and political liberalism in the capitalist democracies.

Conventional economic doctrine in the early twentieth century followed Adam Smith in its belief that the 'invisible hand' would, in the long run, ensure the full utilization of all factors of production. Workers could be fully employed if wages eventually fell sufficiently to balance the supply and demand for labour. However, Keynes saw that even if such equilibrium were eventually to occur, it might come too late to avoid human misery and political unrest – in the long run we are all dead was his famous retort to orthodoxy.

This orthodox economic belief that the self-regulating market mechanism would eventually bring about full employment was firmly entrenched in the British Treasury and the Bank of England. Keynes set himself the intellectual tasks of persuasively demonstrating that the free market and the circular flow between the factors of production did not necessarily ensure full employment and, at the same time, of proposing remedial measures that were consistent with political and economic liberalism. Forced labour in road and railway construction, as practised by authoritarian regimes, was not an acceptable solution.

The General Theory of Employment, Interest and Money was published in 1936, but it was only during Keynes's guidance in securing the non-inflationary full employment of the British economy's resources during the Second World War that his analysis gained widespread acceptance in government. This conversion to his ideas was also reinforced by the political commitment to maintain full employment and to introduce comprehensive social welfare, should the war end in victory. The contention that this new social democratic settlement could be financed if Keynes's theory were put into practice became increasingly persuasive. Full employment, it was argued, would reduce the demand for welfare and social security and, simultaneously, increase tax receipts and contributions from employed workers which would help to finance the new measures. For almost a quarter of a century after 1945, Western democracies believed that Keynes's understanding of the capitalist system had enabled its economic problems to be solved and had ushered in a perpetual 'golden age'. The disintegration of this utopian vision during the 1970s will be examined later; here we need briefly to outline Keynes's basic arguments.

According to classical economic theory, as we have seen, money is a passive element in the economic process; it is considered analytically to be a 'neutral veil' behind which the factors of production of the 'real' economy operate. As money does not bring utility or yield interest, holding it is unproductive and, consequently, the rational maximizing individual will either spend it on consumption or invest it for income or profit. The price mechanism of the 'invisible hand' ensures that these activities bring about the full utilization of society's resources. Thus, as Smith had contended, the individual pursuit of self-interest ensured the maximization of collective societal welfare.

Keynes saw that this theory was appropriate for the barter exchange of what he termed the 'cooperative economy'; but, like Marx and Schumpeter, he argued that it ignored the essential historical fact that capitalism was a 'monetary production economy' with the goal of realizing profits. Here money played a pivotal, but paradoxical, role. On the one hand, money could be used to expand production and employment, but, on the other hand, assets could be sold and the money removed from the system as a store of wealth – in Keynes's terms, 'liquidity preference'. From the purely logical standpoint of classical theory, Keynes agreed that this would not be economically rational – it would be more profitable for the individual and society to invest and consume. However, a preference for holding money did occur from time to time and the hoarding inhibited the accomplishment of the full utilization of resources by society. This state of affairs required an explanation.

Although capitalist activity was based on calculation, which was made possible by money's role as a stable standard of value, uncertainty was an eradicable feature of human existence. Given certain facts, the probability of *risk* could be calculated; but Keynes distinguished this from *uncertainty* – that is, situations and circumstances in which we do not know and have no means of knowing how events will unfold. This becomes increasingly the case the further into the future we try to predict and project our endeavours. In the face of such uncertainty, holding money offered psychological security, but the withdrawal of purchasing power diminished production and consumption.

It was 'liquidity preference' that explained the 'outstanding characteristic' of modern capitalism of remaining in a chronic condition of less than optimum activity for long periods of time without either recovering or completely collapsing. In other words, Keynes was convinced by neither Smith nor Marx. All the evidence indicated that 'even approximately full employment is of rare and short-lived occurrence' (Keynes 1973 [1936]: 249–50). In a world of uncertainty, whether or not money was used as a hedge to lull 'our sense of disquietude' or was invested in production or expended in consumption depended on 'animal spirits' – that is, feelings of optimism and confidence. However, this is not simply a matter of individual psychology. As Keynes implies, it is the institutional structure of the capital market which makes this choice between liquidity (holding money) and investment in production and employment available to individuals.

Finance and the capital market

Keynes observed that stocks and shares have a dual character which, in an uncertain world, means that the mutually beneficial harmonization of individual self-interest (profit) and collective welfare (full employment) is not necessarily achieved. Stocks and shares are both a claim (in the form of dividends) on the long-term profits of business enterprise and, simultaneously, speculative assets whose current price varies in relation to expectations of the enterprise's prospective profitability. In a similar manner to classical theory, today's economic orthodoxy maintains that this dual character of financial assets ensures that the short- and long-term performance of the enterprise and individual and collective welfare are integrated. On the assumption that the share price accurately reflects prospective income based on the company's performance, it is held that enterprise managers will on the basis of self-interest endeavour to maximize profits in order to maintain a high stock-market valuation. High share prices act as a defence against take-over and, if pay is partly in the form of share options, they augment managers' remuneration. These issues will be explored further in part II; here we need simply to note Keynes's critique that the nature of the financial asset was not merely dual, but also potentially contradictory.

A central feature of the stock market is the precariousness of the knowledge on the basis of which estimates of the prospective long-term yield of stocks and share are made (Keynes 1974 [1936]: 149). The risk of uncertainty for shareholders is minimized by the liquidity of the shares on the market – that is, they are readily convertible into money. However, this short-term advantage for the individual creates potential long-term problems for business enterprise and, consequently, collective welfare. The stock market enables individuals rapidly to move in and out of investment. It is as though, Keynes whimsically explains, a farmer, having tapped his barometer after breakfast, decides to sell his farm and take his money out of farming during the morning, only to return it a few days later as the weather improves (Keynes 1974 [1936]: 151). There is, at the most fundamental level 'no such thing as liquidity of investment for the community as a whole' – the result is catastrophic depression (Keynes, 1974 [1936]: 160).

Furthermore, with the 1929 Wall Street Crash in mind, Keynes warned that capitalism would fail to provide for human welfare if investment were to become primarily speculative and its stock markets came to resemble casinos (Keynes 1974 [1936]: 159). Even in the absence of serious collapses, the routine uncertainty about the long-term prospects of an enterprise means that investors are constantly trying to anticipate, in the short term, the valuations of their shares. The resulting opportunity for speculative gains creates a short-term volatility in share prices and, consequently, instability for business. Moreover, speculation diverts money from long-term investment in productive enterprise.

Orthodox economic thinking, however, had a different explanation for the inability of society to achieve the full utilization of its resources – the failure of wages to adjust to market conditions.

The labour market and effective demand

This central tenet of classical economics, revived in the neoliberal economics of the 1980s, held that workers would price themselves out of jobs if they failed to accept lower wages as dictated by the market competitiveness of their firm or industry. Thus all unemployment was 'voluntary' in the sense that it resulted from workers' decisions that a given level of wages was unacceptable as compensation for the 'disutility' of work. However, Keynes argued that unemployment was, in the main, 'involuntary' as, in effect, labour did not have the power to influence the overall level of employment because bargaining determined *nominal* money-wages but not *real* wages – that is, their actual purchasing power (Keynes 1974 [1936]: chapter 19).

Real wages were determined by the combined complex relationship between wages and profits and other prices in the economy, which labour could not directly control. An increase in employment was a possible consequence of a reduction of money-wages, but only if there was an expectation on the part of the entrepreneurs that more workers and increased output would result in greater profits. However, Keynes considered that other outcomes would be more likely. For example, given a competitive producers' market, a reduction of wages might lead firms merely to reduce prices but maintain the same level of output and, therefore, employment. Moreover, if wages were to be reduced this would mean lower effective demand in the economy and the possibility of a downward deflationary spiral as production is cut to adjust to lower consumption.

Keynes argued that private agents – labour or capital – could not easily break the impasse of inadequate effective demand – that is, insufficient purchasing power to maintain full employment. However, Keynes's remedy was not radically to alter the social structure of capitalism – despite his misgivings about the role of the capital market. Rather, he maintained that from time to time capitalist economies were in need of a deliberate stimulus from the 'visible hand' of governments. But they should not, as he put it, take over what was being done, rather, do what was *not* being done.

The management of aggregate demand

For all its virtues capitalism did not automatically produce the level of aggregate demand that was consistent with full employment. Only the government was in a position to do this, but Keynes insisted that, whatever it did, it should not limit individual freedom, which he wished to avoid out of sense of personal conviction. But he was all too aware that any form of public interference in the labour market would be opposed, on the grounds that it contravened the 'strict business principles' that were derived from classical economics. To illustrate his point, he suggested, again with typical whimsy, that it might be acceptable if the Treasury were to bury old bottles filled with bank notes and have private enterprise tender to dig them up, which would have the effect of creating employment and increasing the community's real income (Keynes 1974 [1936]: 129).

In effect, he advocated that governments should use their power to *enable* and *assist* private investment, production, consumption and employment to progress until all resources were fully utilized. It must be emphasized that Keynes never offered simple blueprints and that, after his death, 'Keynesian' was applied to a wide range of policies, some of which were not entirely consistent with his work. However, the basic Keynesian measure requires that governments abandon balanced budgets – that is, they should practice 'deficit finance'.

By their demand for goods and services from the private sector, all governments in capitalist societies create employment, income and further demand in the economy. But conventional 'sound money' and 'strict business principles' held that this expenditure should not exceed tax revenue for fear of introducing too much money into the economy and inducing inflation. However, in order to break an impasse where the level of aggregate demand was insufficient to secure full employment, Keynes advocated that government expenditure should be permitted to exceed revenues from taxation, at least in the short term. This could be achieved by borrowing from the private sector by issuing government bonds and/or by running up an overdraft at the central bank. Such unbalanced budgets would be self-correcting due to a 'multiplier effect' on employment and the consequent increase in tax revenue from the increase in production and employment.

Keynes exposed capitalism's fragile and precarious nature and its inherent tendency to produce unintended and unwelcome consequences. Its performance chronically fell short of its capacity to satisfy human welfare – there was 'dearth amidst plenty'. The 'invisible hand' could not be counted upon to maintain full employment. In the very simplest terms, this was a consequence of the connections between uncertainty, the contradictions between individual interests and collective welfare, and the nature of money in capitalism. In the first place, although money is the source of investment that leads to the employment of labour and the generation of income for consumption, it also provides individuals with the means for withdrawing from enterprise and storing their wealth. The short-term expedient for the individual to deal with uncertainty has unintended long-term negative effects for society as a whole. Second, the existence of speculative markets in financial assets creates price instability that exacerbates uncertainty and can affect employment and production.

As we shall see, speculation is particularly important in foreign exchange markets, where changing exchange rates affect an economy's price competitiveness and level of employment. Keynes was aware that attempts by a government to stimulate aggregate demand would be considered to be inflationary and that this would lead to the selling of its currency and a consequent falling exchange rate which, in turn, would affect domestic conditions (see chapter 4, note 13). Consequently, Keynes's design for the post-1945 international monetary system contained a somewhat contradictory proposal. Worldwide free trade was to be encouraged and supported in all commodities except money. As we shall see, the Bretton Woods international monetary system, which operated between 1945 and the early 1970s, attempted to control international speculative markets in currency and money-capital in order that the democracies could make good the wartime promises to maintain full employment (see pp. 84–6).

Keynes produced a penetrating analysis of the social structure of the capitalist system; but it contained two closely related blind spots. First, he tended to overestimate the efficacy of ideas and intellectual argument and to underestimate the nature of the struggle over the distribution of income. Having dissected the capitalist system, Keynes strongly implied, as did almost all professional economists, that the various groups in society – workers, entrepreneurs, rentiers et al. would all accept the judgements of the technical experts on the measures necessary to produce full employment. Economics, Keynes ventured, would become like dentistry, and, eventually, everyone would recognize the collective benefits of full employment. Second, it is surprising, given the importance he attached to expectations, that he did not consider more carefully the effect of full employment on labour's expectations and power to realize them. These defects were to become much more obvious during the 1970s, but as early as 1944 the Polish economist Michal Kalecki warned, from a left-wing perspective, of the political consequences of full employment (Kalecki 1943). Governments would be forced to discipline the workers' enhanced power and expectations for ever-rising and inflationary wage increases by the deliberate introduction of deflation – an ironic 'reverse Keynesianism'.

Conclusion

Schumpeter and Keynes moved beyond the classical nineteenth-century focus on the material components of the economy – technology and the capital–labour relations in production – to investigate the role played by money. In doing so they departed significantly from conventional nineteenth-century conceptions of money. In essence, both Schumpeter and Keynes held that all money was, in fact, 'credit' of one kind or another. They pointed to the fact that the pace and rhythm of capitalism's dynamic growth was largely dictated by the banking system's 'monetization' of debt, which financed both production and consumption. This pivotal element of the capitalist system, consisting of an entirely new set of banking institutions and practices for the production of credit-money, will be examined in chapter 4. It cannot be too strongly emphasized that these were, as Weber had also noted, unknown in previous types of economy. Their analysis further implies that the locus of power in capitalism lies in the money and credit markets, where Schumpeter's 'merchants of debt' assess creditworthiness and, consequently, determine when and where production takes place and how far credit-financed consumption can absorb it.

3

The basic elements of capitalism

It is possible to discern a gradual shift of emphasis in our classic theorists' analyses of the capitalist economy. Each gives special – but not exclusive – attention to a particular element. Although Smith devoted considerable attention to the way in which capital 'stock' was used to employ labour, he focused on the rapid extension of the division of labour and market exchange in eighteenth-century 'commercial' society. By Marx's time in the mid-nineteenth century, the enterprise factory system was more firmly established, the struggles between capital and labour had intensified, and cycles of economic expansion and contraction had increased in severity and frequency. By the end of the century, more attention was given to the expanding banking system and the increasing role of capital markets. For example, Hilferding augmented Marx's analysis to take the emergence of 'finance capital' into account (see the discussion in Scott 1997: 22–5). But Schumpeter realized that money, banking and finance had been capitalism's most distinctive characteristics from the very earliest stages of development and that these were the key to understanding the system's operation. Obviously, Smith and Marx were not unaware of the monetary and financial side of capitalism, but they looked elsewhere for its definitive features. With Keynes, as we have seen, money takes on even more significance.

Taking these accounts as a whole we can identify three fundamental elements, or institutional clusters, of the capitalist economy:

A. monetary system for producing bank-credit money;
B. market exchange; and
C. private enterprise production of commodities.

A. Monetary system and bank-credit money

Market exchange and enterprise production cannot exist without a viable monetary system. First, the impersonal coordination of sellers and buyers – that is, supply and demand – by price signals in large-scale markets presupposes the existence of a means of exchange and payment. Second, as Weber emphasized, the calculation of costs of production and net profits in the enterprise requires a monetary standard of value (money of account). Third, money-capital for both production and financial speculation is created with loans (debt), produced by a network of banking enterprises which realize a profit from interest. Following Schumpeter, it could be argued that the financing of production with money-capital in the form newly created bank money uniquely specifies capitalism as a form of economic system. Enterprises, wage labour and market exchange existed to some small degree, at least, in many previous economic systems, but, as we shall see, their expansion into the dominant mode of production was made possible by the entirely novel institution of a money-producing banking system. Capital is 'that sum of means of payment which is available at any moment for transference to entrepreneurs' (Schumpeter (1961 [1911])).[1]

B. Market exchange

The exchange of commodities in markets is based on competition between buyers (demand) and sellers (supply), which produces a price at which exchange is acceptable. This mechanism of bids (demand) and offers (supply) coordinates the three phases in the capitalist production of commodities:

(i) finance (money-capital) $\rightarrow$ (ii) production (capital + labour) $\rightarrow$ (iii) consumption.

Bank credit finances investment (in the form of loans, stocks and shares) in physical capital and the employment of labour for the production of both the means of production and of consumption goods in order to realize a profit – that is, Marx's M-C-M_1. As we shall see, capitalism also contains purely speculative markets in financial assets which involve purely M-M_1 exchanges.

All forms of property, goods and services, including the enterprise and its potential revenue, are marketable as financial assets – stocks and shares, bonds, securities and so on. The uncertainty of financial asset price changes over time gives rise to speculative markets involving purely financial exchange in which assets are bought and sold in the expectation of price changes – that is, M-M_1 deals.[2] In this way, capital is endowed with a dual character – as both productive resource and speculative financial asset.

Thus capitalism contains the following basic markets:

a. the money and money-capital markets by which the supply and demand for finance is coordinated and its price (interest) established;
b. the labour market which determines wages;
c. two markets involved in production: (i) the market for production goods (means of production); and (ii) the final consumption goods; and
d. financial asset markets, based on the fact that the title to the ownership of all forms of property in capitalism is represented as a marketable 'asset'.

As the discussion of our theorists has shown, there are two quite divergent analyses of these interrelations. On the one hand, theories deriving from Smith's account of the 'invisible hand' emphasize the effectiveness of the market's decentralized coordination and integration of complex economic systems. In this model of capitalism, competition produces the most efficient outcome in which all resources are fully utilized.

Moreover, economic agents – bankers, workers, managers and so on – are rewarded in accord with their functional contribution, which is, in turn, determined by a competitive process of supply and demand. For example, a shortage in the supply of highly productive labour will lead to the substitution of labour-saving physical capital. Furthermore, this approach strongly implies that the economic integration and efficiency creates social integration by binding economic agents together in webs of mutually beneficial exchange.

On the other hand, Marx, Weber and – to some extent – Keynes point to the power inequalities of the property rights between economic classes and agents and to the fact that the divided economic functions do not simply cooperate, but struggle over the surplus. For example, capital, but not wage-labour, has the right to control the operation of the enterprise and to calculate and distribute profits. Furthermore, this tradition places emphasis on the unintended negative or contradictory effects of market coordination.

By enabling capital to be withdrawn from unprofitable activity and reinvested elsewhere, financial asset markets are an essential source of capitalism's flexibility and dynamism. But, as Keynes warned, this capacity can quickly incapacitate the economy if there is a widespread withdrawal of capital from production and/or consumption and its storage of capital in the form of money. Furthermore, pure speculation under conditions of uncertainty can routinely create asset price bubbles and instability that can perturb the production of goods and services.

Despite these different views on the efficacy and stability of the market mechanism, there is widespread agreement that market competition accelerates economic growth by driving capitalist entrepreneurs constantly to revolutionize the means of production in a process described by Schumpeter as 'creative destruction'.

C. Private enterprise production of commodities

The production of goods and services for sale on the market takes place in private enterprises which are institutionally separated from the household and state, where consumption takes place. Money-capital and wage labour are brought together in the enterprise, which aims to calculate the net cost of producing marketable commodities with an exchange value in order to realize a monetary profit. All means of production are the private property of the enterprise and constitute its physical or material capital. Production is undertaken by legally free labour, employed for wages by the enterprise.

The physical means and money used in the process of production are 'capital' in that they are not owned or controlled by those who directly operate the enterprise – workers and managers. In other words, as Marx explains, capital is not defined by its functional role in the process of production, but by a power relation. 'Money' becomes money 'capital' only with the existence of property-less labour – that is to say, a class of economic agents that can only subsist by selling their only 'property' – their labour power.

With the development of the large-scale corporation, comprising shareholders and salaried managers, it was widely held that private ownership had been separated from control of the enterprise to such an extent that capitalism was no longer an accurate designation of modern economies. However, as we shall see in chapter 6, both ownership and control of capital remain highly concentrated and outside the control of almost all employees.

Private ownership is not necessary for the physical means of production to be capital. States also own means of production, but if workers do not exercise control over their deployment, use and disposal, then it is more appropriate to refer to this as a form of 'state capitalism', rather than socialism. From this standpoint, for example, Saudi Arabia's oil and gas enterprise Saudi Aramco and Mexico's Pemex, as well as communist China's enterprises, are state capitalist.[3]

Again, the enterprise – like the market – can be looked at from two perspectives – as the functionally efficient means for the coordination of economic activity, or as the source of exploitation and site of the most intense conflict between economic agents and classes. These different conceptions of the enterprise will be examined in chapter 6, but here we should note that coordination within the enterprise is not based on the 'invisible hand'. As Marx and Weber insisted, the wage contract does not merely specify the terms of the contractual exchange of effort for reward; it also entails the workers' subordination to the 'visible' authority of the owners and controllers of capital.

These elements A, B, and C comprise a structurally differentiated 'economy' which is, in Polanyi's terms, 'disembedded' from other non-economic institutions in society. Decisions about production and distribution of goods and services in the market capitalist economy are taken on the basis of an economic rationality – that is, costs of production and relative prices. In pre-market society the organization of production and distribution is 'embedded' in families, communities, manorial households or states. For example, the division of labour in simple hunter-gatherer societies was embedded in communal and familial relations. Men made tools and weapons and hunted; women made utensils, gathered vegetation and cooked. All labour was devoted to production for basic subsistence and use, not exchange; and distribution was governed by norms of in-group reciprocity. Traditional agrarian communities largely distributed production in accordance with an ethic or charity (Weber 1981 [1927]: 356). In empires – such as ancient Egypt – the surplus was collected and redistributed as rations by the central bureaucracy (Polanyi 1971 [1957]).

However, as we shall see, two crucially important related points must be borne in mind. First, the separation of the economy as a complex of distinct institutions does not mean that it is completely separate and autonomous from the other parts of society. Second, the market and other basic elements of the capitalist economy are not self-reproducing or self-regulating – that is to say, Smith's 'perfect liberty' of freely contracted exchange relations did not emerge spontaneously. Rather, the 'free' market and all other institutions of the capitalist system – the enterprise, the banking system and so on – are all produced and maintained by state law, norms and cultural beliefs. As Marx emphasized in his critique of Smith, the revenues (rent, profits/interest and wages) received by the factors of production (land, capital and labour) were the result of the social relations of production – that is, property relations. Property gives capital the legal right to organize production in the enterprise. These issues will be examined further in part II; here we need simply to outline the main points for consideration.

The state

In simple terms and notwithstanding considerable variations between different countries and across time, relationships between the state and the structurally distinct market capitalist economy are the outcome of the mutual accommodation between the emerging capitalist bourgeoisie and the early modern state, described by Weber as the 'memorable alliance' (see pp. 32–4). The struggle between monarchs and merchants for control of opportunities for profit-making was resolved by a tacit agreement in which the bourgeoisie ceded their claim to rule in exchange for the right to make money in conditions secured and protected by the state. In return, the state was financed by taxation and loans from the propertied classes. In short, as we shall see in more detail in part II, capitalism is characterized by two interdependent sources of power – the state's legitimate use of force and the private ownership and control of economic resources (capital).

Modern capitalist states provide:

(i) a level of social order within which peaceful economic activity can take place;
(ii) an institutional and legal framework which specifies the rights of the various economic agents and the rules of competition and exchange – that is, the laws governing property rights and contracts between buyers and sellers;
(iii) a range of services and 'public goods' that would appear to be necessary for an effective capitalist economy, but which private enterprise is either reluctant or unable to undertake – for example, a sound currency, education and welfare to maintain the quality of the work force ('human capital'); and
(iv) attempts to correct the market's failure to achieve acceptable outcomes – for example, financial crises or

persistent unemployment. In return, these activities are financed by taxation and loans with the consent of the economic interests of civil society.

Each of these 'functions' can be considered from the different perspectives on the operation of the capitalist system that we have encountered. Some would argue that the state's actions are based upon a disinterested search for the most effective and efficient means of running capitalism. Others contend that the regulation of the economy is the outcome of a conflict between irreconcilable interests that does not necessarily produce the most efficient outcome. In this regard, the Marxist perspective maintains that the state exists to ensure the dominance of capital and subordination of labour.

The scale and scope of the state's direct intervention and participation in the economy is continuously contested in a way that could almost be said to define the nature of politics in modern capitalist societies. On the one hand economic liberals, taking Smith as their guide, argue that the market has a capacity for self-regulation and, consequently, state involvement should be kept to a minimum. On the other hand, radical critiques, based in varying degrees on Marx, contend that market capitalism is crisis-prone and founded on economic inequality. State power should be used to curtail the depredations and destructive consequences of the capitalist class. Various 'middle' or 'third' ways have been sought, which seek to harness the productive efficiency of market capitalism to the attainment of politically determined goals and values – equality of opportunity, social justice, the eradication of poverty, health and even 'happiness' (for a critical survey of 'third way' discourse see Callinicos 2001).

The balance of power and interdependence between states and capital is characterized by a particular articulation of sovereign territorial space and market networks at the international level. Although capitalism is dependent on the social peace that states can bring about, it is by nature extraterritorial. In the most fundamental terms, what we now see as globalization may be understood as an acceleration of the process whereby capitalist networks and markets extend across the world. In this process, the complex relationship between the two 'logics' of political and economic power is revealed (see the discussion in chapters 8 and 9).

As we shall see, the idea that there exists a mutually reinforcing connection, or 'elective affinity', between the liberal democratic state and capitalism is well established in the social and historical sciences. Most obviously, as we have noted, Smith's 'perfect liberty' of the market has its foundation in the politically liberal state. Weber agreed and drew further connections between citizenship and capitalism. Furthermore, it is argued that modern representative democracy is an almost inevitable consequence of economic and political liberty. As I have already suggested, these issues are of the utmost contemporary importance as capitalism continues to spread across the world and in doing so encounters hitherto unreceptive regimes and forms of state in Islamic countries and communist China.

Culture and capitalism

Like all social systems, capitalism is 'cultural' in the sense that its economic activities are guided, framed and rendered meaningful to the participants by shared symbols, norms, beliefs and values.[4] Attention has been given to two main issues: the 'spirit' of entrepreneurial capitalism, and acquisitive consumerism. Capitalism is historically distinctive in that both production and consumption are freed from the limits set by traditional cultural constraints. Some level of luxurious 'conspicuous consumption' is to be found in all except the simplest subsistence-level societies, but only in modern capitalism does it become a major motive force in the economy. In short, if the culture of capitalism is unable to generate an ever increasing expansion and proliferation of consumers' wants, then the economy falters and enters a period of stagnation.

As Weber observed in late nineteenth-century Silesia, where traditionally limited patterns of consumption had not entirely disappeared, it was proving futile to increase the peasants' output by offering monetary incentives (Weber 1981 [1927]: 355). Raising the rates simply led the peasants to reduce their effort to the point that gave them the previous level to meet their customary level of consumption. Applying the same logic to enterprise production, Weber posed the question of why, in the absence of any economic compulsion, the early capitalist manufacturers persisted in their pursuit of profits far beyond the point at which their own consumption needs had been met. As is well known, he identified a distinctive 'spirit of capitalism' in which the pursuit of gain by the unceasing calculation of net profit had become an end in itself, rather than a means to affording a culturally prescribed style of life. But how did these entrepreneurs make sense of their historically atypical activity? Why, in early capitalism before competition in product markets, did they make profits only to plough them back into the enterprise? Protestantism's distinctive 'ethic', Weber famously concluded, had an 'elective affinity' with the 'capitalistic spirit'. The 'calling' to work and the glorification of God by the good stewardship of his gifts to humanity gave meaning to the relentless calculation and pursuit of profit for the improvement of enterprise, as opposed to mere avarice and greed.

In modern capitalism the compulsion to pursue profits now has a purely structural foundation; that is to say, it is driven by the quest for survival in competitive markets and by the demands of shareholders for dividends.[5] Nowhere is this more evident than in the absolute exigency that consumers' wants are stimulated without limit, lest falling demand triggers a recession and a downward spiral of factory closures, unemployment and ultimately social and political unrest. Marx's 'fetishism of commodities' is now institutionalized in the culture of modern capitalism, and personal identity in modern capitalism is largely achieved by the display of a distinctive pattern of 'lifestyle' of 'conspicuous consumption' (Slater 1997; Veblen 1994 [1899]).

However, it has recently been argued that purely materialist incentives fuelled by insatiable consumption demands can never provide sufficient basis for the continued willingness of individuals to participate in the capitalist system (Boltanski and Chiapello 2005). Unbridled hedonism, selfishness and greed can never provide an ethical legitimation for capitalism and, consequently, they will continue to attract critiques of the system. Paradoxically, this continually stimulates the formulation of new ideological justifications, that is to say, a 'new spirit of capitalism' which emphasises the 'collective benefits defined in terms of a common good' that it is claimed capitalism can produce (Boltanski and Chiapello 2005: 1–55). For example, discourse in management texts has appropriated values from the 1960s countercultural critique of capitalism and used them to characterize new non-hierarchical forms of work organization in which individuals can realize autonomy and self-expression.

With the exception of culture, these fundamental elements – the market mechanism in the capitalist economy, the monetary system and the production of bank-money, enterprise production and the struggle for its surplus, financial assets, and the state's roles in capitalism – will be examined separately and in more detail in the following chapters.