**CAPITALISM HANDOUT Chapter 4**

Everyone knows that the United States is a capitalist country. All levels of government, from the federal government down to local government, make decisions that influence how solid and vibrant our capitalist economy. We pay attention when "The Fed" raises or lowers interest rates. Some of us choose our favorite merchants by focusing on the values and bargains to be had there while others focus on the quality of goods or services and choose their favorite stores accordingly. Every day, from the micro issue of my decision to get a latte on the way to work to the macro issue of whether the Federal Reserve will raise the interest rates by a quarter of a percent, we are fully immersed participants in a capitalist society.

We're proud of capitalism and promote it to the rest of the world. Language referencing capitalism is common in public discourse: Presidents and corporate leaders make speeches about capitalism. Media types write articles and blog about capitalism. For the rest of us, capitalism is something we occasionally talk about. And, yet, many of us spend little time thinking about some of the basic aspects of capitalism.

## A. What is capitalism and where did it come from?

As indicated in the Terms & Concepts, **capitalism** is an economic system in which all (or, modernly, most) of the critical components of production - raw materials, land, machinery, end products - are privately owned and managed for profit. Capitalism is to be contrasted with **socialism**, in which the components of production are owned and controlled by the government.

**Private property** is property (including real property, personal property [e.g., goods & movables] and intellectual property) that can be owned by a person or corporation. The rights of private ownership include the right to exclude others or to dispose of the property (e.g., through sale of it to another) as the owner wishes. Given that, by definition, all of the critical components production are privately owned in a capitalist system, it is clear that private property is central to capitalism.

Experts find the earliest forms of modern capitalism in the merchant capitalism that flourished in ancient Rome, the Middle East in the ninth century and in Europe during the Middle Ages. During this time, wealthy merchants evolved and they provided the capital necessary to establish large enterprises (trading companies) involving the distribution of goods for profit. (For example, a trading company might by all of the cloth that a village or guild could weave, transport the cloth to a place where there was greater demand for it, and, then, sell the cloth for a profit.) At the height of the Roman Empire, goods were transported long distances for profit and Arabic cultures have a long history of mercantilism along ancient trade routes. And, we all know that Christopher Columbus set sail in order to find a shorter route to "the Indies" (e.g., Southeast Asia).

By the late 18th century, the industrial revolution had begun and merchant capitalism had evolved into industrial capitalism (i.e., what we refer to as capitalism in the West). The wealth that had been acquired by merchants during the era of merchant capitalism was turned to the acquisition of the machines that could manufacture products.
In 1776, **Adam Smith** wrote **The Wealth of Nations**, a book considered by many to be the seminal writing on economics. The ideas it contained continue to reverberate in the United States and the rest of the world.

Smith believed in individualism. He believed that humans are acquisitive by nature - that we are eager to acquire things - and that we are traders by nature who seek to acquire desired products by barter and exchange or buying and selling. He also believed that, in these barter and exchange transactions, we strive to get the better bargain - the better deal.

Smith believed that governments should not regulate or interfere with the marketplace. He promoted ***laissez faire*** ("Let people do as they please") capitalism because he believed that markets can be self-regulating. He believed that, if individuals were allowed to buy, sell and exchange without government restraint, the forces of **competition, supply and demand** would control markets. Thus, driven by the self-interest of many individuals, markets would be moved by an **"invisible hand"** to a point where the right amount of product was being supplied at the right level of quality and at the right price. And, this would provide the greatest good for the greatest number.

Most people associate capitalism with the free, unrestrained market philosophy of Adam Smith. Smith's theories appeal to many people, including Ronald Reagan, and his idea of self-regulating markets is frequently espoused in current political discussions.

## B. The Theory of Self-regulating Markets - Supply and Demand

Proponents of self-regulating markets (i.e., people who believe that government should not regulate markets) believe that markets function best when they are unregulated and they maintain that, in unregulated markets, the interrelated forces of supply, demand and price will dictate the optimal number of products produced and the optimal market price of those products.

Note: Supply is the amount of a given product that is available or can be produced. Demand is the amount of a product or service desired by consumers.

The theory of self-regulating markets goes like this:
1. If there is insufficient or declining demand for its product at a given price, the seller will lower the price or reduce the supply to meet the limited demand.
2. If there is great or increasing demand for its product at a certain price, a seller will raise the price or increase the supply while keeping the price static.
3. Thus, the price of a product will adjust to a point of equilibrium, where supply and demand are equal. (I.e., price reflects the supply of and the demand for a product or service.)

Pure, unregulated markets (markets over which there are no government regulations) may work fine when a market is comparatively small. That is, if the market is somewhat small, it may well self-regulate and do so efficiently. But, when the scale becomes very large or when the producer's "gear up" or "gear down" time becomes significant for other reasons, the ability to act quickly to fluctuations in demand is diminished. Instead of humming along in a nice, comfortable balance, large, unregulated markets tend to swing from boom to bust, causing financial injury and much stress. For example, in the Great Depression markets collapsed because they were largely unregulated and the experience of the Great Depression - what we learned from it - caused many economists and policy leaders to reconsider *laissez-faire* capitalism. Thus, experience has shown that there are deficiencies in the theory of unregulated markets.

## C. State Welfare Capitalism

All modern, western industrial societies have mixed economies in which government regulations influence free market forces in order to achieve social objectives or protect the interests of different groups. And, so, America's capitalism now involves a regulated marketplace. Like all modern, western capitalist countries, ours is now a system of **state welfare capitalism**. Over time, government restraints have been imposed in order to curb the boom-bust cycle that is threatened when markets are unrestrained, to address other problems associated with unregulated markets (e.g., **monopoly & oligopoly**), and to achieve a variety of other social goals.

One of the most significant regulations of the domestic market is the Sherman Antitrust Act. Monopolies and trusts (combinations of businesses) concentrate wealth and market power in the hands of a few and are thought to threaten normal market competition resulting in unnaturally high prices, low quality, etc. To prevent trusts from creating restraints on trade and reducing competition, Congress passed the Sherman Antitrust Act in 1890. The Sherman Act is the main source of antitrust law in the U.S. and it was designed to maintain economic competition and liberty by making restraints on trade or competition illegal. In addition to this federal law, almost all states have laws prohibiting monopolies, price fixing agreements, etc.

To summarize, the two dominant, competing economic models on the earth are capitalism and socialism. Capitalism's theoretical ideas were articulated by Adam Smith but all modern, western, capitalist countries have embraced systems of state welfare capitalism. Even as modified, most economists conclude that capitalism is more efficient and more productive of widespread material benefits than socialism and the economic and political struggles of the Soviet Union may represent the superiority of capitalism. However, notwithstanding its value in enhancing overall wealth and efficiency, critics point out that economic inequality and individual, economic insecurity are common attributes of capitalism.

**D. Key Features of Capitalism**

The essential features of capitalism are:
1) Private property,
2) Freedom to decide whether or not to buy or sell,
3) The profit motive,
4) A marketplace that includes buyers and sellers, and
5) Competition in the marketplace.

**E. Moral Defenses of Capitalism**

Those who defend capitalism offer a number of moral justifications, including the following:
1. There is an inalienable, natural right to private property and capitalism is the economic system that flows naturally from private property. (Critics of this justification might reject this absolutist approach to property in favor of, say, a relativist approach seeking the approach to property that achieves the greatest good. Others dispute the necessary connection between private property and the right to sell that property for a profit.)

2. There is an inalienable, natural right to individual freedom and capitalism is the economic system that flows naturally from individual freedom. (Critics might argue that there is no logical connection between individual freedom and the concept of private property.)

3. Capitalism is the best way to achieve economic progress; it is more efficient and productive than any other system; better than any other system, it brings wealth and affluence to nations and to the individuals residing in those nations.
(Critics might avoid challenging the broad assertion and, instead, focus on the shortcomings of capitalism.)

**F. Moral Criticisms of Capitalism**

Those who object to capitalism offer a number of moral criticisms, including the following:
1. Capitalism creates and perpetuates a society characterized by economic inequality; that it's a **zero-sum game** in which, by and large, the rich stay rich and the poor stay poor. They argue that the total amount of wealth remains constant and the poor stay poor because the prospects of a child born in the barrio or ghetto are categorically different from those of a child born into an upper middle class, professional home.

2. The theory of individual freedom that is central to capitalism is a fiction because:
a) Consumers have no choices except those offered by large corporations;
b) Advertising overwhelms free will, because products today are so complicated (e.g., machines or processed foods) that informed product comparisons are impossible; and
c) Consumers are not able to match the power of industries in the setting of prices or the shaping of markets.

3. The theory of a competitive marketplace that is central to capitalism is a fiction because:
a) The long-term trend has been toward the concentration of a few, super-large corporations in a given market (i.e., **oligopolies**). (Defenders assert that antitrust laws are designed to preserve a competitive environment.)
b) **Corporate welfare** programs protect businesses from competition or failure. (The text says that, every year, the federal government provides subsidies to private industry totaling $85 billion. Included are such things as giving $6.6 million to Sunkist to promote oranges, $4.9 million to Ernest & Julio Gallo to promote its wines internationally and $1 million to M&M Mars "to improve customer recognition of its product." Not included in the $85 billion figure is "an estimated $200 billion over a ten-year period bailing out the savings and loan industry.") (Defenders assert that protectionist tariffs, corporate subsidies and corporate bailouts preserve domestic jobs and the competitiveness of American businesses in a global economy.)
c) Given a choice between profit and competition, American industry always chooses profit. Protectionist government policies ensure corporate profit, but stifle competition and the resulting benefit to consumers. (Again, defenders might argue that these policies preserve domestic jobs and the competitiveness of American businesses in a global economy.)

4. Capitalism destroys the good in people in several different ways including the following:
a) While it may be true that people are acquisitive by nature, capitalism (and, especially the advertising modernly associated with it) corrupts human beings by reducing their aspirations to that of merely acquiring things.
b) Capitalism brings about the exploitation of workers. (Defenders of capitalism might assert that the 20th century witnessed progressive protection of and benefits to workers.)
c) Capitalism causes alienation in workers by reducing tasks to routine, repetitive, uncreative and unfulfilling tasks. (Defenders might argue that workers are well paid for their labor or that modern, humanistic management styles minimize worker alienation.)

**G. Challenges Facing America's Economy**

Our economy, the economic well-being of our business institutions and the economic well-being of American workers are currently facing a number of significant challenges, including the following:
1. The American economy - its gross domestic product - is growing at a significantly slower rate than it did from 1870 through 1970. Similarly, the growth rate of our overall productivity has slowed.

Since growth in these areas is necessary in order to improve our standard of living, our standard of living may stagnate or level off.

2. Domestic manufacturers are increasingly getting out of the manufacturing business. **Outsourcing** is gaining strength, especially outsourcing to foreign manufacturers. Some former manufacturers are now **hollow or weightless manufacturers**, having no ownership of manufacturing capability. Thus, the service portion of our domestic economy is growing while the manufacturing portion is shrinking. A number of economists believe that the United States cannot maintain long-term economic strength without a strong manufacturing base.

3. Recently, domestic companies have begun to outsource service functions (e.g., computer technical support, medical lab diagnostics) to foreign countries. Some observers do not see how the U.S. economy can survive if the U.S. both manufacturing and service jobs are exported.

4. The attitude of the average American worker toward her or his work may be changing. Some surveys indicate that the number of people with the traditional **work ethic** is diminishing and some commentators believe that a strong work ethic is essential to increasing domestic productivity.

5. In order to be more competitive at this moment and to respond to investor's demands for return on investment, most corporate managers focus on short-term results. As a consequence, corporations may be losing the ability to be competitive in a global market in the long term.

6. Mergers and acquisitions increase the concentration of capital and production or service in fewer and fewer business entities, thus reducing competition in the marketplace.