

How Capitalism Works

By Julia Layton, www.howstuffworks.com

For a lot of us, the real thrust of economics is our checking account balance. But recent events like the Enron debacle, the proposed privatization of [Social Security](#) and the [subprime mortgage](#) disaster have turned popular interest to economic principles in a way we usually see only in the wake of a [stock market](#) crash. Economics -- and more specifically, **capitalism** -- is hitting close to home.

The essence of capitalism is economic freedom. Practices like ill-conceived subprime lending and crippling corporate fraud are side effects of a system that revolves around the individual's right to pursue his or her financial goals without the government getting involved. Capitalism's key early thinker, Scottish political economist **Adam Smith**, may have wanted economics separated from politics for its own good, but economics is nonetheless entwined with ideas about the individual's place in society. This connection has politics written all over it (witness the shouts of "Die capitalist pigs" heard around the world).

There are really only two basic approaches to a modern (non-barter-based) economic system, although you'll find endless variations on these two approaches throughout the world. One type of economy is the **free market economy**. That's capitalism. The other is the **planned economy**, which some people call a **command economy** or a **Marxist economy**.

In this article, we'll explore capitalism: its roots, principles and effects, benefits and shortcomings. We'll find out how capitalism compares to the alternative method of doing business. Incidentally, the United States doesn't actually practice capitalism. No one does these days.

Real Capitalism: The Idea

Before the [Industrial Revolution](#) in the 1800s, countries like Britain and the [United States](#) had true capitalist economies. With industrialization, though, came sweat shops, social protest and resulting government intervention in the form of fair labor laws. That's when real capitalism ended.

Today, the economies of nations that are typically referred to as capitalist are in fact **mixed economies** -- they incorporate certain aspects of capitalism and certain aspects of planned economies. In pure capitalism, things like child labor laws, Social Security, anti-discriminatory hiring practices and a [minimum wage](#) have no place. Capitalism rejects all government intervention in economic matters.

The basis of capitalism is **individualism**. The economic system stems from humanistic ideals of the 18th century European Enlightenment -- beliefs that each human being is individually unique and valuable. This mode of thinking was a turning point. Before the Enlightenment, governments didn't talk about human rights. But in this vision of humanity, a society made up of unique individuals who pursue their individual interests is healthy -- it's characterized by progress, spiritual and worldly wealth, and liberty. Individuals are not just free to pursue self-interested goals; they should pursue self-interested goals.

It's easy to see how this shift in social consciousness became the basis of capitalism. If self-interest is a good thing, and personal wealth is a self-interested goal, then widespread personal wealth is a good thing. And if individual welfare leads to overall social welfare, then individual wealth leads to overall social wealth.

The added philosophical view that turns the social concept of individualism into the economic concept of capitalism came from Adam Smith in the late 1700s. His book, "An Inquiry into the

Nature and Causes of the Wealth of Nations," had a profound effect on economic principles. Before Smith, the economic self-interest of the individual was seen as counterproductive -- or at least non-contributory -- to the economic welfare of society as a whole. Smith disagreed with this belief. He suggested two concepts that ultimately became the basis of capitalism:

- Because self-interest guides producers to create exactly what people want, the pursuit of personal gain eventually benefits society.
- An economy has a natural design. Left to its own devices -- and removed from politics, religion and all other pursuits -- it will regulate itself. As long as no one throws a spoke in the wheel, the economy will work the way it's supposed to, and everyone will benefit.

Smith's overall view is that an "**invisible hand**" guides the economy through the combination of self-interest, private ownership and competition. The end of this natural economic balance is general social wealth. In other words, everybody benefits.

How can private profit lead to public good? On the next page, we'll learn about the process of capitalism.

Buy Buy Buy!

Capitalism creates and thrives in a consumer culture. If no one's buying products, the system breaks down. The social effects of a society that defines itself by what it buys or possesses, not by what it creates, can be seen in widespread, astronomical credit card debt and, to some, violence for the pursuit of material goods.

Ironically, in 1904, German political economist **Max Weber** tied the development of modern capitalism to the rise of the Puritan work ethic, which soundly rejects the accumulation of wealth for wealth's sake. He reasoned that Protestantism and the Puritan work ethic paved the way for capitalism by proclaiming the spiritual righteousness of worldly life pursuits.

Capitalism Terminology

Finance Capitalism: An economic system in which the product is money instead of goods. Profits are obtained through the buying and selling of foreign currencies and financial products like stocks and bonds.

Marxist Economics (or Planned Economy): In the late 19th century, Karl Marx proposed an anti-capitalist economic system. Instead of private ownership for personal gain, Marx promoted public ownership for collective gain -- goods distributed throughout society based on need. Marxism is the basis of the communist economic systems of the former USSR and, until recently, China.

Mixed Economy: A system that incorporates components of pure capitalism and components of a planned economy.

Monopoly Capitalism: A system in which the means of production are all privately owned by huge corporate conglomerates that bring in exorbitant profits by eliminating the competition component of the free market.

Pure Capitalism (also Laissez-Faire Economics, Market Economy or Free Market): A system in which the government doesn't interfere. The system works on the principle of a Free Market, in which all financial dealings are controlled by private producers and consumers. Through private ownership, competition and self-interest, the economy achieves a natural balance and maintains the overall economic good.

State Capitalism: An economic system in which the means of production are privately owned, but the state controls the market to various degrees.

Real Capitalism: The Practice

In Smith's model, there is a natural economic order that produces the greatest good. Government interference interrupts this natural order. His theory of capitalism plays out like this:

- There is an **owner class**: The means of production (capital) are owned only by the few people (capitalists) who can pay for them. Modern means of production are things like machines, factories and land.
- There is a **working class**: The people (laborers) who use capital to produce goods and have no ownership of that capital. Capitalists pay the laborers with [wages](#) ([money](#)), not with the products the laborers produce. The laborers use that money to purchase the goods they want. In this way, no one who purchases goods (the consumer) has any real connection to those goods.
- **Rational calculation for profit** guides production: The capitalists try to judge the market and adjust production accordingly in order to realize the greatest possible profit.

- Society is made up of **consumers**: Because people are disconnected from the goods they produce, the process of buying things, not of creating things, becomes the primary way in which people define themselves.
- The more profit the capitalists bring in, the more goods they produce. The more goods the capitalists produce, the lower the price of those goods. The lower the price of goods, the more people can afford to buy, and the higher the **standard of living** throughout society.

The government's only real role in capitalism is to maintain peace and order so the economy can work without interruption. This **laissez-faire** (anti-interference) system of economics relies on interconnected, self-regulating networks of producers, consumers and markets that operate on the principles of **supply and demand**.

Essentially, when more people want something, supply goes down and price goes up. When fewer people want something, supply goes up and price goes down. In the end, it's all about finding a way to turn a profit. Profit results from obtaining or producing goods for less than you sell them for. This core value of capitalism dates back thousands of years to a practice known as **mercantilism**. On the next page, we'll look at how capitalism may owe its very existence to the spread of Islam from the [Middle East](#) to [Europe](#).



The Venetian merchant [Marco Polo](#) traveled along the Silk Road to China. Mercantilism gradually supplanted local barter systems.

MPI/[Getty Images](#)

The Rise of Capitalism

Unlike capitalism, which revolves around production, mercantilism revolves around trade. The core of mercantilism is the simple practice of selling something for more than you paid for it. It's based on the concept of profit, and it grew out of man's mobility.

Mercantilism came to thrive in the non-localized, well-organized societies of [ancient Rome](#) and the Middle East. When most of the world still worked on the **local barter system** of exchanging goods, merchants in these cultures moved goods from place to place, which enabled them to profit.

If something like pottery clay or wheat were abundant locally but scarce in a distant town, merchants brought those goods to towns where they could fetch a higher price. This type of economic mobility was possible because of the relative peace and order of these well-developed societies.

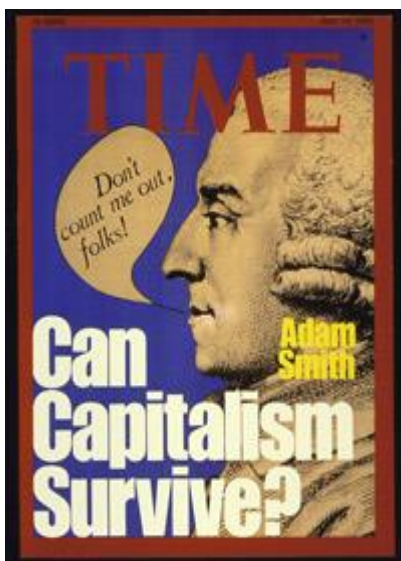
In the 5th century, the decline of the Roman Empire also meant the decline of widespread mercantilism in Europe. But mercantilism continued to thrive throughout Arabia. Arabs, who were predominantly Islamic, were positioned perfectly for a profit as goods moved along Middle Eastern trade routes between [Egypt](#), [Persia](#) and the later Roman and [Ottoman Empires](#). The rapid spread of Islam in the 700s brought the practice of mercantilism to Africa, Asia and parts of southern Europe. From [Spain](#) and [Portugal](#), mercantilism spread to the rest of Europe, which resumed its mercantile economic system by the 14th century. Over the next 500 years, mercantilism became what we now call capitalism.

By the 19th century, capitalism was the dominant economic system in most of the world's established nations. Soon after capitalism became the most popular economic system, it also became one of the most despised. In the next section, we'll look at why this economic principle evokes such passionate viewpoints.

What else is there?

In ideal terms:

- In a **capitalist** economic system, the owner of production is the individual, and the benefactors of production are first the individual and second the society.
- In a **socialist** or [communist](#) economic system, the owner of production is the state or the society, and the benefactor is the society.
- In a **fascist** economic system, the owner of production is the state, and the benefactors of production are first the state and second the society.



A 1975 Time Magazine cover pondered the future of capitalism with a little commentary from the political system's foremost thinker, Adam Smith.

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Evolving Economics

Capitalism clearly goes beyond economics. It's impossible to talk about capitalism without talking about political and social viewpoints. Capitalism is rooted in views about individual rights, liberty and human nature. In theoretical capitalism, the world revolves around the individual, the individual is inherently good, and individual self-interest benefits society as a whole.

But what happens in the actual practice of capitalism is sometimes quite a different story. With the establishment of an owner class and a working class, the distribution of wealth becomes extremely uneven. When the laborer is dependent on the capitalist for his livelihood, distrust, anger and unrest may develop. These basic truths have led to the end of pure capitalism throughout the world. What we now call capitalism is in fact a mixed economy. The exclusion of government from economics just didn't work.

Beginning in the early 1900s, governments started intervening to protect the working class from the owner class. In the U.S., Congress passed laws that made [child labor](#) illegal, capped the length of the work day and banned monopolies. To some, the [anti-trust laws](#) of the 1920s seemed to go against the values of capitalism, which they partly did. However, competition is also crucial to the self-regulation necessary for capitalism. Monopolies eliminate competition, which means the economy is no longer in its natural state.

The 1929 [stock](#) market crash and the subsequent Great Depression brought about more changes. Franklin Roosevelt's New Deal administration created jobs with the purpose of raising employment levels and poured government money into the economy to try to end the depression. Congress passed the [Social Security](#) Act -- removing the worker's complete control of his or her earnings. The mandatory withholding of pay was meant to protect workers from capitalism's natural ups and downs. Mandated unemployment insurance did the same.

In the 1930s, the British Economist John Maynard Keynes published a new take on capitalism. Keynes believed that government intervention can help stabilize a capitalist economy. By varying taxes and spending and manipulating interest rates, the government can keep the money supply level and protect the economy from the "boom and bust" periods inherent to the capitalist system.

Keynes' economic theories contributed to the U.S. Congress passing the Employment Act of 1946, which put the responsibility of economic stability squarely in the hands of the federal government. With that, laissez-faire economics was officially dead in the United States.

No one is sure what the future holds for our evolving economy. The "market" is now the entire world. China, which was the last major country to maintain a Marxist economic system, has in recent decades introduced elements of capitalism to its economy in order to join the global marketplace. Traditionally capitalist countries like Britain, Canada and the United States have increasingly introduced restrictions on economic activities in order to promote the general social good.

The call for universal healthcare in the United States hints at a further swing toward the socialist economic viewpoint that individual self-interest does not necessarily lead to overall social welfare. With no purely capitalist nor purely planned economies left among the world's major financial players, and with the expansion of far-reaching trade agreements, the future of economics seems to point at a broad market that, economically at least, all but erases national borders and connects the world through financial mobility.

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