CHAPTER 5

Understanding and Evaluating Economic Systems

What functions must an economy perform?
How is the economy linked to the society?
How can we judge whether the economy is serving the society well?

We now need to establish some principles on which our subsequent explorations into political economy can be based. Having reviewed in the preceding four chapters the broad sweep of issues with which contemporary political economists are concerned, it is time for a change of gear. We must establish more carefully the nature of the economic enquiry itself. This means discussing what an economy is and does, what forms economic organisation can take, and how economic activity links generally with social structure. It also requires some preliminary consideration of how we can judge the performance of an economy in meeting social goals. It is through looking at these issues that we also start to see some of the sources of conflict in the process of political economic enquiry.

ECONOMIC FUNDAMENTALS

The economy can be understood most simply as the means whereby goods and services are produced, exchanged, and distributed among the members of a society. Incomes and wealth are generated through these processes of production, exchange, and distribution. These incomes are more or less evenly shared—creating outcomes that can be egalitarian or markedly inequitable. The wealth can be more or less wisely used—for immediate consumption, for reinvestment in increasing the productive capacity of the economy, or for wasteful purposes associated with military or environmental destruction, for example. Over time, the volume and value of the income-generating economic activities may either expand or contract—this means either economic growth or stagnation and slump.

Looking at the economy in this way draws attention, first and foremost, to the system by which we provide for our needs, individually and collectively. The most basic need is for food, then for clothing and shelter. Providing for those needs is the most basic economic activity; thus, farmers and fishermen are more fundamental to economic activity than financiers. By similar reasoning, clothing manufacture and housebuilding are also basic economic activities, although many of the products now made—fancy clothes and suburban palaces—go far beyond the satisfaction of our basic needs. Indeed, a vast array of products is made in modern economies, which
satisfy desires that are psychological rather than physiological and, arguably, are created through the functioning of the economic institutions themselves. Notwithstanding the difficulty of distinguishing needs from wants in practice, the point remains: the basic function of the economy is the practical task of 'provisioning'. The processes by which those produced goods and services are exchanged, and how the resulting incomes and wealth are distributed, may involve complex financial arrangements. Certainly this is true of capitalism, and may explain the common perception that economics is 'all about money'. However, as defined here, the basic and universal feature of all economic systems is the use of tangible resources—natural, human, and manufactured—for making goods and services.

Economics is the discipline that studies these issues. It analyses the production and exchange of goods and services, the distribution of income and wealth, the disposition of that income and wealth, and the material factors shaping social progress or social regress. Economists have always claimed that, by casting light on these concerns, they can help us gain more control over the economic factors that shape our existence. This is not to claim the capacity to illuminate all the factors that influence our happiness or well-being—spiritual considerations and the quality of social life are excluded from such a material calculus—but it is indicative of the essentially social purpose of studying economics. The social purpose is to contribute to human betterment. By understanding the causes of poverty, recessions, and low productivity, for example, economists can contribute to pushing back at least some of the constraints on our well-being, individually and collectively.

So, wherein lies the distinction between economics and political economy? It rests largely on the claim by contemporary political economists that mainstream economists have, in practice, abandoned this social mission in favour of a narrowly constructed set of abstract theories that reveal little about how the economy actually operates. Political economy is distinguished by its emphasis on the broader view of economic enquiry—its social purpose and its political application. Two different aspects of this interpretation of political economy can be identified:

- Political economy emphasises that economic issues cannot properly be studied independently of their social context. It adopts a broader definition of the subject than mainstream economics, seeking links with insights drawn from other fields, such as sociology, political science, industrial relations, history, and geography. This gives a distinctively interdisciplinary character to political economy—albeit with material economic concerns as the central focus.
- Political economy emphasises that the way in which economic issues are analysed cannot be wholly value-free. The selection of issues for study, the distinctive assumptions made, and the form of investigation are all pervaded by judgments. So, a value-free analysis is unattainable. The important thing is to make the values explicit, rather than leave them implicit, masked by claims about the scientific status of the discipline. Better blatant than latent.

From these two fundamental propositions, many other features of political economy emerge: the emphasis on evolutionary processes rather than equilibrium states; the emphasis on equity and sustainability, as well as efficiency; and the emphasis on the role of the state, as well as the market in shaping economic outcomes, for example.
These are central themes to be developed in subsequent chapters. Their common concern is understanding the social character of economic activity.

ECONOMY AND SOCIETY

What shapes the relationship between economy and society? The functioning of the economy does not take place separately from the functioning of other aspects of social life. Political economists have repeatedly stressed the need to study the 'social embeddedness' of the economic system to analyse how it is related to the construction and reproduction of social order.²

Five dimensions of the interaction between the economy and society can be distinguished.

Markets

Production for exchange is a pervasive feature of economic activity. Markets, as the processes and places where those exchanges occur, are therefore of central importance, both economically and socially. Market interactions impose discipline on the participants in the economic system: sellers cannot sell whatever they want for whatever price they like, nor can consumers buy whatever they want for whatever they would like to pay. Exchanges will only occur when they are expected to be mutually advantageous. An effective market mechanism creates the conditions for such outcomes, but it cannot thereby resolve all economic problems. For example, there may be circumstances in which no goods and services are available because of interruptions to the production process, or because misallocation of income causes buyers to come to the market with markedly uneven purchasing power. An economy in which markets play a central role depends on certain social underpinnings—an acceptance of commercial contractual obligations as a legitimate and enforceable foundation for personal interactions, for example. In turn, it also tends to leave its clear stamp on the prevailing social structures and attitudes—emphasising market values and material acquisition as the key indicators of social worth and social position.

State

Economic processes of production, exchange, and distribution can be organised by the state rather than left to the operation of market forces. The state in this respect can be considered as comprising all the institutions of national and regional administration, including the government, the public service, and the judiciary. Its most direct economic role in production is through public-sector business enterprises—hence the importance of political decisions about the balance between nationalisation and privatisation. Its other regulatory activities and its tax revenue-raising and expenditure functions are also fundamentally important in shaping economic activity in the private sector of the economy. How these aspects of state involvement in the economic system are constructed and blended is an intensely political issue. A society in which
economic provision is state-centred can be expected to be more collectivist in character than one in which private enterprise dominates. But how the state is controlled then becomes the key issue.

Class

Class relationships are another central feature of the interaction between economy and society. If, for example, some people own the means of production (factories, tools, machines, etc.), while others have only their labour to sell, that gives rise to a distinct class divide. It is likely to be associated with sharp differences in income, wealth, and power. It is the source of potential social conflict—although some degree of cooperation between classes is essential if the economic system is to continue to function. Indeed, it is this uneasy blend of conflict and cooperation that is the hallmark of a class society. It should also be noted that, while class differences are rooted in economic conditions, their social manifestations—differences in social status and social behaviour, for instance—are often very complex and cannot be simply ‘read’ from class position.

Gender and ethnicity

Gender and ethnicity also shape economic functions and social standing. A ‘sexual division of labour’ is said to characterise economic arrangements in which men and women characteristically do different jobs. Likewise, people of different ethnic background are often located in different segments of the labour market. In both cases, this can be seen as the result of discrimination—although it may be deeply rooted in economic and social institutional procedures and not merely the result of personal prejudice by individual employers. Sexism and racism are pervasive ideologies, and sexist and racist practices can be institutionally embedded. They cause inequalities of economic opportunities and economic rewards, which are systemically structured according to gender and ethnicity. How such inequalities interact with one another, with class relationships, and with the balance between market and state in economic organisation is complex and changeable.

Ideology

Ideologies can be understood as systems of belief that shape behaviour, individually and collectively. In general, one would expect such ideologies to reflect the existing material economic conditions—hence the association between consumerist values and an economic system geared to the production of ever more goods and services, for example. However, dominant ideologies are continually challenged by rival, dissident beliefs. Therein lies an important impetus for change in economic and social organisation.

These five dimensions of the relationship between the economy and society can be regarded as the ‘glue’ holding the political economic system together and determining how it works. How the elements are constructed varies considerably from country to country, and over time. The relative importance of market, state, class, gender, ethnicity,
and ideology in shaping economic and social order varies enormously. How well these different arrangements work is also the focus of endless debate in political economy. The ‘glue’ can sometimes fail and the system come unstuck.

EVALUATING ECONOMIC PERFORMANCE

Understanding economic organisation—its different forms, diverse interpretations, and social implications—is the first task of political economy. The second is to evaluate economic performance. If political economy is to contribute to social progress, this essentially normative dimension is necessary in our deliberations. We need to know what works well and what does not. For this purpose, we need reasonably clear criteria of evaluation. The following four are suggested.

Efficiency

Any economic system should make efficient use of the available resources—natural, human, and manufactured. However, what efficiency really means in this context remains open to debate. The avoidance of waste is certainly implied, but what constitutes waste may itself be a matter of judgment. In practice, efficiency has multiple dimensions. There is efficiency of resource utilisation—not leaving resources unused, as occurs, for example, whenever there is a significant incidence of unemployment in a region or nation. There is efficiency of resource allocation—ensuring that the goods and services produced are those that the members of the society actually want to consume, for example. There is efficiency of resource creation—fostering the most productive development of the workforce, for example, or of new production technologies through innovation. In respect of these three dimensions, we need to remember that efficiency implies a means to a particular end or ends: it is not an end in itself.

Equity

The economic system should distribute its fruits in accordance with our social standards of equity. Equity implies fairness. Therein, of course, lies plenty of scope for different interpretation. Some people interpret equity as requiring equality of economic outcomes, such as equal incomes for all members of the population. Others stress the more modest goal of equality of opportunity, accepting major income inequalities as long as all have an equal opportunity to succeed. On either reading, inequalities associated with systemic patterns of social differentiation according to class, gender, or ethnicity violate the equity ideal. For practical purposes, the degree of inequality in the overall distribution of income or wealth is usually taken as a rough primary indicator of the extent of equity in different types of economy.

Sustainability

We also require of an economic system that it be sustainable. In other words, it must be capable of reproducing itself. That means not using non-renewable natural resources, or using renewable resources at a faster rate than that at which they are
Replenished. The extent of harmony between the economy and the physical environment is obviously crucial here. Economic growth based on a rapacious attitude to the environment clearly fails this sustainability test. Sustainability has its economic and social dimensions, too. Economically, it is crucial that productive equipment subject to wear and tear through its use in producing goods and services be maintained and/or periodically replaced; consequently, a sustainable economy must involve foregoing some current consumption in order to ensure sufficient productive investment in capital goods. Socially, sustainability also requires that the relationships between classes, genders, and ethnicities be sufficiently stable for people to continue cooperating in economic activity. For this to happen, those relationships must be perceived as legitimate and acceptable; otherwise, social turmoil, even revolution, may eventuate.

Compatibility with social goals

The ultimate test of an economic system is whether it serves society well. Does it generate the necessary goods—the food, clothing, housing, and other material requisites for a contented society? Does it produce the quality health and educational services necessary for a healthy and well-informed citizenry? Generally, is it conducive to personal and community development, to personal freedom, to cultural enrichment, or to the realisation of spiritual as well as material goals? These are the higher social purposes against which the mundane contributions of the economy need to be judged. Therein lies a host of difficulties—identifying the relevant social goals and their relative importance, deciding how they can be measured or otherwise assessed, and learning how political judgments can be made about trade-offs between them. On such contentious matters there can never be unanimous agreement. There are also good reasons to expect that the character of the prevailing economic system will itself have a major bearing on the pattern of prevailing social aspirations—so an objective test is elusive. However, if nothing else, such considerations are a reminder of the need to take a broader view of the economy and of economic progress than that based on the conventional economic indicators.

What measure of progress?

The overall performance of a national economy is conventionally measured according to gross domestic product (GDP), which is the sum of the market value of all goods and services produced in a country during a year, irrespective of whether they are produced by individuals, private business enterprises, or government institutions. If this sum is greater than the preceding year’s, then economic growth is said to have occurred—which indicates effective performance. Conversely, no growth or, worse, a decline is held to be indicative of relative economic failure. League tables are commonly constructed on GDP per capita to indicate the ranking of the different countries of the world in any one year according to this performance measure. In principle, the measure can also apply to subnational areas (gross regional product or gross city product) and to the world as a whole (gross planetary product).
Figure 5.1 Growth or progress? GDP and GPI indicators.

Adapted from: (a) The Genuine Progress Indicator: Summary of Data and Methodology, Redefining Progress, September 1995; (b) H. Daly and J. Cobb, For the Common Good, Beacon Press, Boston, 1994, New Economics Foundation; (c) C. Hamilton and R. Dennis, Tracking Well Being in Australia, Australia Institute, Canberra, December 2000.
Notwithstanding its widespread application, this conventional measure of economic performance is subject to numerous problems. For example:

- It excludes many useful goods and services that are produced directly for personal consumption rather than for sale. Much domestic household production—disproportionately performed by women—is of this character.
- It includes expenditure on goods and services whose production is only necessary because of the damage done in the process of producing or consuming other goods and services. Expenditures on pollution control devices and vehicle smash-repair are obvious examples. These ‘defensive expenditures’ add to GDP, but there is no net contribution to community well-being.
- No account is taken of the rundown in the stocks of environmental resources that may occur in the process of producing marketed goods and services.
- The time and effort involved in producing goods and services does not enter into the calculations. By inference, leisure is economically worthless.
- The distribution of the products is not considered. So, the production of frivolous, luxury consumption items for the wealthy counts equally with the production of basic necessities for the poor.

Reflecting on these problems, one economist has described conventional national measures, ‘the crown jewels of economic statistics’, as ‘almost trivial indicators of anything worth measuring’. The need to construct better indices of progress is being increasingly widely recognised. For example, attempts have been made to construct a genuine progress indicator (GPI). This deals with the above problems by adding estimates for the value of non-marketed production, subtracting ‘defensive expenditures’ and the costs of environmental decay, adding the value of leisure, and weighting the index according to the degree of inequality in the income distribution. Such GPI estimates may be ‘rough and ready’, but the results often provide a striking contrast to the conventional GDP indicators. Illustrative outcomes (based on somewhat different calculations of the GPI) are shown in figure 5.1 for the United States, the United Kingdom, and Australia. In each case there is a striking contrast between GNP and GPI measures of national performance. The inference is clear—that increasing the volume and value of marketed economic products does not reliably constitute progress.

CONCLUSION

There are various ways in which economic activity can be organised. Identifying market, state, class, gender, ethnicity, and ideology as dimensions of economic and social order draws attention to the array of organising principles and institutions. It draws attention to the complexity of the interrelationships between the economy and society. There are also various ways in which economic performance can be evaluated. Identifying efficiency, equity, sustainability, and compatibility with social goals indicates the most important dimensions. It also draws attention to some of the deficiencies of narrowly constructed conventional economic indicators, such as GDP.

These considerations make necessary the exercise of judgment in political economic analysis. Indeed, the scope of political economic enquiry itself is a matter
of judgment. While the economy and economics can be reasonably clearly defined—in terms of production, exchange, and distribution—there is no line clearly dividing the economy from society, or economics from the other social sciences. There are also inescapably normative elements involved in analysing and evaluating economic systems. The delineation of the discipline is made yet more complex by the recognition that capitalism is only one among many types of possible economic organisation.
CHAPTER 6

The Distinctive Features of Capitalism

What different systems of economic organisation are possible?
What is special about capitalism?
What are the common features of capitalist economies, and what are the differences?

Economic activity can be organised in various ways in the attempt to satisfy the social purposes we have identified. Communal, slave, feudal, capitalist, and socialist systems are usually distinguished as the principal alternatives. Capitalism is evidently the predominant system at the present time. A careful definition of this system is required before theories about how it works are studied and judgments about how well it works are made. This is attempted in this chapter, first by contrasting capitalism with other ways in which economic activity can be organised, and second by looking in more detail at its distinctive features.

ALTERNATIVE ECONOMIC SYSTEMS

Economic activity can be organised communally. In small social clusters, for example, members of the society can gather to decide what they will produce, how the tasks will be shared, and how the fruits of their economic effort will be distributed and used. These decisions may be strongly influenced by custom and convention. Such has been the case in many tribal societies, a traditional focus in anthropological studies. The term primitive communality is often applied in this context, although the structure of economic and social processes may actually be highly sophisticated. Whether such communal organisation constitutes a viable basis for a large-scale, industrial economy is a moot point.

Socialism may be regarded as the application of collectivist principles in the context of a modern advanced economy. The central organising principle is collective decision-making. The nature of the economic activity performed, who performs it, how it is performed, and where and when it is performed are determined by a planning process. Therein lies much of the appeal of socialism, in principle at least, as a rational, democratic, and egalitarian set of socioeconomic arrangements. Whether these principles can be implemented in practice is one of the major debates of contemporary political economy. There were some controversial twentieth-century experiments—in the former Soviet Union, for example—but whether these embodied socialist principles in practice is a contentious matter. There is no single model of socialism: 'market socialism', for example, strikes a different balance between planning and markets from a
command economy, in which the allocation of economic resources is determined by the state. Similarly, socialism may be based on either centralised or relatively decentralised decision-making processes—although the attractive latter variant has to deal with the seemingly pervasive tendency to centralisation and authoritarianism, which violate the 'ideal' principles. Rethinking socialism as a viable basis for economic organisation in the twenty-first century is a big challenge.1

A third possible means of economic organisation is slavery. Historically, this has been an economic system of considerable significance. Explicit use of force or coercion by one class (slave-owners) over another (slaves) is the central organising principle. Violence (or the threat of it) is the driver of economic activity, determining what gets done, by whom, how, where, and when. Slavery was commonplace in the Mediterranean lands, which were the cradle of modern Western civilisation, but it has also been crucially important in the recent economic development of a number of countries. No analysis of the United States, for example, could sensibly ignore the role of slavery in its economic development: slaves from Africa were the principal source of plantation labour and, after emancipation, became a major source of labour in industrial cities like Chicago and New York. A significant part of Great Britain's wealth in the eighteenth century derived from slavery, too. Coerced labour was also important in Australia, where convict labour was used to build infrastructure, laying the foundations for subsequent economic development. 'Indentured labour' from the islands of the South Pacific also provided a sizeable workforce, especially on the Queensland sugar plantations. Residual elements of slavery persist today in other nations—the use of child labour and prison labour to produce cheap products is very similar to slavery.

Feudalism is a fourth means of economic organisation. It, too, is of considerable historical and contemporary significance. Like slavery, it has coercive elements, but the core differentiating principle is mutual obligation. Under feudalism, the different social classes are linked by a system of mutual rights and obligations, usually based on traditional roles and beliefs. Serfs work on the land of landowners in exchange for social 'protection'. This was the norm during the Middle Ages in England and much of Western Europe. Derivatives of this system continue to shape the economic development in many of the poorer nations today. The control of any economic surplus over and above the requirements for social reproduction is in the hands of a landlord class. Social conventions and religious ideologies are usually woven into the structures of reciprocal obligation, ensuring at least some degree of social acceptance of what might otherwise be deemed unacceptable inequalities of class, social position, and power. The demand for 'land reform' is the usual signal of a move to challenge and change these residual feudal arrangements. Even in modern industrial societies, control over land—both access to it and the use of it—continues to be a significant factor determining the distribution of the economic surplus. However, what most clearly distinguishes feudalism from capitalism is the switch from an economic and social organisation based on mutual obligation to one based on monetary relationships.

Capitalism, broadly speaking, is the economic system in which financial considerations dominate. It is a system in which the quest for financial reward is the driving force shaping what is done, by whom, how, where, and when. It also determines
'who gets what' in the distribution of rewards. Work is done for wages; business activity is undertaken for profit. The primacy of these pecuniary relationships is the basic defining feature of capitalism. The pecuniary character does not preclude some collective decision-making, coercion, or mutual obligation, but it does pervade the economy and society.2

THE DISTINCTIVE FEATURES OF CAPITALISM

Capitalism cannot be defined as easily as we may define 'chair' or 'elephant': we do not so readily know it when we see it. A definition that is to serve as the basis for political economic analysis, showing capitalism as a cluster of interconnected characteristics, has to be set out more fully. The following eight features, summarised in figure 6.1, identify what is special about the system. Each is not unique to capitalism, but together they convey its distinctive character.

![Diagram](image)

Figure 6.1 Elements in the capitalist system.

Private ownership of the means of production

Capitalism is based on a distinctive system of property rights. Economic resources are characteristically owned by private individuals and institutions. Some economic resources—land and other natural resources, or public utilities supplying such things as electricity, gas, water, and public transport—may be owned by society as a whole. However, this is an aberration, at odds with the basic capitalist principle of economic activity being in the hands of private businesses. These businesses may be run by individuals, such as sole proprietors of small firms, or by institutions legally recognised as entities, such as corporations owned by shareholders with limited liability.
The capacity of these property owners to derive income from their control over the means of production—the factories, offices, plant, and equipment with which goods and services are produced—identifies them as a distinct class. How that capitalist class is constituted depends on how numerous the small businesses are and how widespread the shareholdings in the larger firms are. Its existence as a class does not mean that internal conflicts of interests cannot occur—indeed, the owners of rival business enterprises are usually pitted against each other—but its defining feature is a common interest in the pursuit of profit.

The labour market

Under capitalism, those who do not own the means of production depend for their economic livelihood on the sale of their capacity to work. That requires the existence of a labour market (or, more usually, a set of labour markets, segmented according to region and occupation). The buyers of labour—those who own and control the means of production—interact there with the sellers of labour. Sometimes there is direct negotiation of wages and employment conditions between individual buyers and sellers, but the negotiation process is usually mediated by trade unions, employer associations, and regulatory institutions that set the ‘rules of the game’. However, the dependence of the bulk of the population on the sale of their capacity to work (in either manual or mental labour)—that is, the existence of a working class—is the common feature.

Workers under capitalism are free in that, unlike slaves or serfs, they are not tied to a particular employer by force or convention. However, their freedom is a constrained freedom—the freedom, and the necessity, to sell their capacity to work. This is why capitalism is sometimes said to be a system of ‘alienated labour’, or a system in which labour is treated as a commodity.

The capital market

Those who establish and run capitalist businesses need funds for that purpose. They need financial capital before they can employ the means of production in order to make goods and services. So, an institution (or group of institutions) is necessary for channelling funds from savers into the hands of businesses or people who can then invest those funds productively. Banks carry out that institutional function by passing on depositors’ funds in the form of loans to businesses. Indeed, they can lend much more than they have in deposits—effectively ‘creating’ money in the process. As such, banks are key capitalist institutions, facilitating the conversion of savings into investment as well as being themselves profit-seeking entities.

However, the most characteristic capital market institution under capitalism is the stock exchange. This is where shares in companies are sold to the public, and where the owners of those shares can sell them to others. Not surprisingly, the stock exchange is sometimes held to be the ultimate symbol of capitalism. It is a place where fortunes can be made or lost. However, it is really an adjunct to the productive economy, not in itself a place where wealth is created. Indeed, large companies often make such
enormous profits that they can finance and expand their businesses without having recourse to major revenue-raising on the stock exchange. In effect, the capital market has become partly internal to capitalist businesses. External capital markets usually continue to exert some discipline on those businesses, though, if only because the threat of takeover becomes more likely when a firm’s share price falls.

The land market

Land is of fundamental importance in all types of economic organisation. In a rural context, its fertility and the efficiency of its stewardship determines its capacity to contribute that most basic of human needs—food. In an urban context, its use has a major bearing on the effectiveness of cities as focal points of modern economic life. So, how land is owned, allocated, and regulated has major socioeconomic implications.

Under capitalism, land is characteristically privately owned and is usually allocated through market processes—subject to varying degrees of regulation by the state. Land, like labour and capital, is bought and sold in the market. Arguably, this is not essential for capitalism: land could be owned collectively through the state, while labour and capital continued to be subject to market processes and conflictual class relationships. As such, the form of land ownership is not such a fundamentally defining feature of the economic system under capitalism as it is under, say, feudalism. However, the very generality of market processes under capitalism makes land yet another tradeable commodity.

Markets for goods and services

Capitalism is a system of generalised commodity production. The production of goods and services for exchange in the market makes those goods and services commodities, that is, items produced for sale rather than for personal use by their producer.

The processes of exchange sometimes involve direct interaction between buyer and seller, but usually they are mediated by the institutions of wholesale and retail trade. Shopping is the name of the game! Indeed, shoppers play a crucial role in the capitalist system as a whole because, if their purchases do not match the volume and array of commodities produced, economic crises may occur. No wonder the emphasis on consumerism is so pervasive under contemporary capitalism, and no wonder so many resources are channelled into marketing and sales promotion.3

The distinctive role of the state

The fifth characteristic of capitalism is, at first sight, more surprising. Surely, one might think, if capitalism is primarily a market economy, then there is no significant role for the state. Not so. In all economic systems other than anarchism the state has a significant presence. The key point is what form the state presence takes. This can be expected to reflect the systemic features we have already discussed.

Thus, under capitalism, the state regulates and enforces the property rights on which the capitalist economy is based. It determines the rules underpinning the operation of
markets for labour, capital, land, and commodities. It may act as an umpire in respect of rivalries between businesses that might otherwise be sources of economic instability. It may seek to redistribute 'market' incomes in order to ensure social stability. It may also be directly engaged in the provision of goods and services that are not otherwise provided because of 'market failure'. The market predictably fails to provide some goods and services because people who do not pay for them cannot be excluded from enjoying the benefits of their provision; that is why fire-fighting, law enforcement, and defence, for example, are normally provided by government. The nature and extent of these state activities is the focus of continued political debate, of course. The point here is that capitalism is not synonymous with a pure 'market economy'.

Distinctive ideology

All economic systems have ideologies associated with them. What matters is how the dominant ideologies are shaped by, or reflect, the structure of the economy. Determining the direction of causation is a highly contentious exercise, but some broad correlations are clear enough. For instance, the consumerism mentioned earlier (or, generally, the emphasis on material goods as the source of personal satisfaction and social status) is by no means unique to capitalism, but it seems to reach its zenith in this type of economy. *Homo economicus* is fostered by capitalist economic interests.

An emphasis on 'competitiveness' seems to be a similarly predictable characteristic of an economic system based on competing market interests (although monopoly may be as prevalent as competition in practice). By contrast, ideologies emphasising cooperation can be expected to be prominent where the economic organisation is collectivist in character. Both types of ideology are usually present, in uneasy alliance with each other. However, to the extent that ideology legitimates an economic system, it is not surprising that the predominant capitalist ideology is consumerist and competitive.

Expansionary tendency

Last, it is pertinent to note the *dynamic* character of capitalism. As a system driven by the quest for profit, it is geared for growth. This is not to say that growth is always achieved—indeed, the history of capitalist development worldwide is of alternating periods of boom and slump. However, this particular type of economic system works best when it is growing. It may be said that, like a bicycle, it requires forward motion for its stability. That is why periods of recession or economic stagnation precipitate dramatic processes of economic restructuring, as described in chapter 3.

This dynamism is capitalism's most obvious strength, the source of its capacity to reproduce itself, expand, and adapt. It is also perhaps the source of its most fundamental tensions. There is perpetual conflict between the profit-seeking interests and the broader goals of society, as the former continually challenge the prevailing social structures. There is also a fundamental tension between this growth-oriented economy and the finite character of the planet on which it exists, a tension that is manifest in growing environmental stresses.
CONCLUSION

Defining capitalism in terms of a cluster of key characteristics does not produce a simple picture. Even the above eight-part representation is significantly simplified. It is a description of an 'ideal' model. It is not necessarily ideal in the normative sense of being desirable (the pros and cons of that come later), but in the sense of being a simplified abstraction of a complex reality. The question remains: do economies in the real world—national economies, for example—approximate this 'ideal' model? In other words, are the economies of the United States, the United Kingdom, Australia, Sweden, Singapore, and other 'capitalist' nations essentially the same? Posed in this blunt manner, the question has to be answered in the negative. The range of economic functions undertaken by the state; the character of the economic institutions that shape the functioning of markets for labour, capital, and land; and the prevailing ideologies in those countries all have significantly different characteristics. In the United States, for example, the state has been more concerned with supporting the interests of capital and the functioning of the capitalist market economy than in Sweden, where the state has played a substantial role in the redistribution of income and in economic and social planning. On the other hand, the United States is highly 'interventionist' on a world scale, much more than Sweden (or any other country), because of its role as self-appointed policeman of international capitalism.4

These examples illustrate variations on capitalism in different national contexts. The variations are partly explicable in terms of the historical evolution of the countries concerned. They can also be analysed in terms of the relationships between the economy and society discussed in chapter 5, that is, the character and 'mix' of market, state, class, gender, ethnicity, and ideology in each case. If we are to understand different countries and how their economies work, there is no substitute for detailed historical and institutional study on a case-by-case basis. The distinctive methodological position being argued here—the punchline to this chapter—is that a necessary prelude to those investigations is an analysis of capitalism in general. Once we understand its fundamental features, we are then in a better position to 'layer on' the details necessary for a comprehensive understanding of the complexities of the real world in which we live.
CHAPTER 7

Economic Theory in Historical Perspective

Why theorise about the economy?
What has shaped the theorising about capitalism?
How have different analyses of capitalism evolved in the history of economic thought?

Having defined capitalism as a distinctive system of economic organisation, our task now is to understand how it works. For this purpose we must theorise. We have to abstract from the complexity of the economic system in the real world in order to focus on the essential or core elements. But what are these core elements? Which theory is appropriate? This chapter begins the process of exploring the competing economic theories about capitalism.

WHY THEORISE?

For many people, ‘theory’ is a pejorative term. It is something to be avoided if possible. This understandably wary attitude is encapsulated in the familiar expression ‘that is all very well in theory, but in reality …’. The inference is that theory is inferior to the direct study of the reality ‘out there’. The problem is that reality is so, so complex. How can we begin to understand it?

To avoid theory, we may elect to undertake a direct, down-to-earth, empirical examination of the capitalist economy in practice. So, we sally forth into the real world—or at least our local region of it—armed with clipboard and pencil (or computer ‘notepad’), and look around. Where shall we look first? At the shops: their vast array of goods, the relative prices of the goods, and the fluctuations in demand and supply for these goods? At the factories, where those goods are produced: the production technologies, labour relations, wage rates, and other determinants of the costs of production? At the docks and airports, to see which goods are being exported and imported and how their relative prices compare? At the volume and values of transactions on the stock exchange and other financial markets? Or at the array of economic activities undertaken by governments: providing goods and services, redistributing income through taxation and public expenditures, and engaging in myriad regulatory economic functions? The list of possibilities is mind-boggling. The body of evidence we would accumulate would be indigestibly huge. Without guidelines to distinguish between what is important and what is less relevant, the task is unmanageable. We have to rethink our investigative strategy.

In effect, we are forced to accept the need for some simplification. This process of simplification is the essence of theory construction. We select particular key variables
for study and set aside the rest as not being of fundamental importance. We are then able to investigate the nature of the relationships between the key variables. We try, thereby, to develop a sequential process of analysis to help us understand the complex world around us. As the economist Kenneth Boulding put it: 'Knowledge is always gained by the orderly loss of information, that is by condensing and abstracting and indexing the great buzzing confusion of information that comes from the world around us into a form we can appreciate and comprehend'.¹ To quote another prominent American economist, 'knowing how to simplify one's description of reality without neglecting anything essential is the most important part of an economist's art'.² In other words, we cannot avoid theorising. Some degree of abstraction from reality is unavoidable. The question is how it can most effectively be done without 'losing touch' with reality altogether (a common criticism of conventional economics). On which aspects of the economic system should the theory focus? Which aspects can be safely neglected? It is because economists are not agreed on these matters that economics as a discipline is pervaded by competing economic theories.

This is where the story starts to get interesting. These questions bring us directly to the central theme of the book: the contest between different 'ways of seeing' the capitalist economy. Of course, the existence of competing theories is not unique to economics; it is characteristic of most academic disciplines. Indeed, some would say it is the hallmark of an open society. However, in economics, the existence of different 'ways of seeing' is particularly problematic. In part, this is because economic ideas have influence on the behaviour of governments and other economic institutions. In part, it is because of the interconnectedness of issues of economic methodology and matters of political philosophy. The different viewpoints in economics reflect different ideas about the nature of knowledge in general and the construction of economic knowledge in particular. The different 'ways of seeing' also partly reflect different political perspectives—conservative, liberal, and radical—about the way in which the economy functions and how it should function. These are the bases of fundamentally different views about capitalism and social progress.

COMPETING 'SCHOOLS OF THOUGHT'

In order to understand the diverse theories about the economy, it is useful to distinguish between competing schools of thought. In effect, this enables us to cluster similar or related theories and make the number of competing theories more manageable. It is a particularly useful means of understanding both the history of economic thought and current political economic debates.

This notion of a school of thought has much in common with the concept of a paradigm. The term 'paradigm' gained particular prominence as a result of a book by Thomas Kuhn called *The Structure of Scientific Revolutions* (1962) in which he described the development, not of economics, but of the physical sciences.³ The central question is how new theories may overthrow existing orthodoxies. Kuhn argued that such transformations periodically occur, often in a quite dramatic manner. For example, the belief that the Earth was the centre of the solar system was challenged in the sixteenth century by some upstarts who sought to demonstrate
that the Earth actually revolved around the Sun. They were ridiculed and persecuted, but eventually their view came to replace the earlier one; it proved to be more consistent with empirical observations and had fewer anomalies requiring explanation. The Sun-as-the-centre-of-the-solar-system paradigm replaced the Earth-as-the-centre-of-the-solar-system paradigm.

We can think of a paradigm as a framework of analysis that defines the issues to be studied and the methods to be applied in studying them. Competing paradigms, Kuhn argued, have been common in the physical sciences. At any time, one paradigm tends to predominate. This constitutes a period of 'normal science'. A clear research agenda is set, but at the expense of limiting the questions that the discipline poses. That eventually becomes a hindrance to further significant scientific progress; anomalous observations proliferate, and a period of crisis occurs. A new paradigm emerges, resolving at least some of the anomalies, and new questions are posed and a new research agenda set; thus, science evolves, not in a linear fashion in which the edifice of knowledge is steadily built brick-by-brick, but through periodic revolutions that open the way for surges in scientific advance.

There are some important differences between the physical sciences and the social sciences, including economics. In the social sciences, the object of the enquiry is constantly changing. Evolution is a feature of the physical world, too, of course, but economic and social conditions are subject to rapid change, which makes for particular difficulties in economic and social analysis. Theories that may be appropriate at one time are rendered inappropriate by changed circumstances resulting from the passage of time. Capitalism today is not what it was a century ago: its institutional features have changed dramatically, even if its essential character has some significant elements of continuity.

This problem is further complicated by the interdependence of theories about social phenomena and the behaviour resulting from those the application of those theories. To give an obvious example: how we understand the economy influences the nature of economic policies implemented by governments, which then changes, at least to some degree, how the economy operates. Again, this problem of interdependence of subject and object is not unknown in the physical sciences, but it is particularly prevalent in economics and the social sciences. Even the process of studying people's behaviour can radically change their behaviour: they act differently when being observed or monitored.  

Last, it is pertinent to note that the development of economics, and the social sciences in general, is permeated by the influence of material interests. Particular theories may suit the requirements of particular individuals, classes, or nations. Because they serve a useful function for the vested interests they support, they can hold out against competing arguments and contradictory evidence. The contest of economic ideas is intertwined with the conflict of economic interests.

This last consideration helps to explain why rival schools of economic thought seem to have such durability. They do not slink away when trounced by superior explanations of economic phenomena. Their persistence is doubly remarkable in light of the first of the above considerations—the changing character of the economy in practice. Economists are continually modifying their theories—the professional journals are full of such adaptations—but the core principles have remarkable tenacity.
The ‘conversations’ among practitioners of each school of thought and between practitioners of different schools of thought in books and journal articles have a rhetorical character. The emphasis is on a process of persuasion; it is a contest of economic ideas. It should already be clear that this is not a purely academic contest. The political purposes that economics serves also have to be taken into account in any serious analysis of the development of schools of economic thought.

AN HISTORICAL OVERVIEW

The essentially political character of economic thought is most obvious when the subject is studied in historical perspective. Over more than two and a quarter centuries, paralleling the development of the capitalist economy, the competing schools of economic thought have argued about how capitalism works. Figure 7.1 provides a simple summary of the evolving currents of economic analysis.

![Diagram of economic thought history](image)

**Figure 7.1 The history of economic thought.** This chart of the main currents of political economic analysis in historical perspective simplifies the complex history of the subject; however, it does draw attention to the principal avenues of continuity (represented by the continuous vertical lines) and discontinuity (represented by the dotted lines). In the former, the new school of thought is a development from the previous one; in the latter, it is a reaction against it.

Each of these competing schools of thought can be understood in terms of the changing economic conditions of the time, the influence of particular economic interests, the influence of prevailing intellectual fashions, and the innovative ideas of great economic thinkers.

Much of the rest of the book is an illustration of these themes. All that remains for this chapter is to make some prefatory remarks about each of the major schools of thought, setting the scene for the more detailed investigations that follow.

It is sensible to begin in the late eighteenth century, when capitalism was clearly emerging from feudalism in Great Britain and, more haltingly, in other nations in which capitalist economic relationships were eventually to predominate. This was
the period when Adam Smith wrote his seminal book *An Inquiry into the Nature and Causes of the Wealth of Nations* (usually shortened to *The Wealth of Nations*) and when what we now call classical political economy became established. Of course, there had been earlier considerations of economic phenomena: the capacity for people to reflect on the economic conditions affecting their lives knows no time limits. However, with classical political economy we can see the emergence of a specifically capitalist economics.

The classical political economists were concerned with studying the economic character of the society in which they lived. They reflected on the propensity of an economic system based on market exchange, rather than customary relationships or state management, for increasing national wealth. They believed this because such a system opened up opportunities for individual initiative, increased productivity, and the growth of trade. (Some did have grave reservations about whether the mass of the working population would experience rising living standards, however.) The ‘economic liberalism’ characteristic of these diagnoses and prognoses has been one of the strong currents in much subsequent economic thought. It continues to have a major influence today.

The theories of neoclassical economics built on the foundations of classical political economy. They have been a consistently strong source of support over more than a century for the view that free markets produce efficient outcomes. Emerging in the late nineteenth century, neoclassical theory provided a formal modelling of equilibrium conditions in competitive markets. This was clearly an attempt to put economics—then newly separated from the study of history and politics—on a more ‘scientific’ basis. (Whether the result was and is actually more scientific or more ideological, showing capitalism in an unrealistically favourable light, is a seemingly perpetual controversy.)

Meanwhile, Marxist economists, also starting from a basis in classical political economy, have taken a markedly different stance in their interpretation of capitalism. They have argued that the operation of such an economy generates pervasive economic inequality, social conflict, and periodic crisis. This quite different analysis of the capitalist economy also emerged in the nineteenth century, responding to the economic, social, and political transformations then taking place. The pioneering analysis of Karl Marx, and his collaborator Friedrich Engels, continues to lay foundations for radical critiques of the capitalist system, such as those frequently advanced by critics of the corporate globalisation process of the present time. On this reasoning, only a fundamental transformation of the political economic system can reconcile economic concerns with social justice and social progress.

Between these extremes are reformist political economic perspectives, such as those associated with John Maynard Keynes and with the institutional tradition of analysis. These also warrant careful consideration, for they particularly focus on what governments can do—given the political will—to eradicate unemployment, redistribute incomes more equitably, and promote more balanced economic and social development.

The institutional economics tradition had its roots in the ‘historical school’ of the nineteenth century and was propelled by the critical social analysis of the dissident American economist Thorstein Veblen. Veblen was deeply critical of capitalism, but
his critique was quite different from Marx's, emphasising the social manifestations of business behaviour and economic inequalities rather than the forces for change generated by class conflict. The political tenor of the institutional economics tradition after Veblen has usually been more concerned with the amelioration of the problems of capitalism than with a revolutionary challenge to the system. It can be argued that the development of the welfare state in the twentieth century was due to the thinking of these institutional economists, as well as the work of other social reformers.

Keynes, writing between World War I and World War II when unemployment was particularly pervasive and persistent, also saw economic analysis as a means towards reform. He considered the capitalist system 'morally objectionable' but thought it better than the possible alternatives: communism and fascism, support for which was then growing internationally. Understanding the causes of unemployment, and positing solutions for it through enlightened economic policy, would, on this reasoning, make a particularly valuable social contribution. As with institutional economics, this was a perspective in which the state was necessarily central. As historian Eric Hobsbawm put it, Keynes 'wished to save the essentials of a capitalist system but realised that this could be done only within the framework of a strong and systematically interventionist state'. It was in contributing to such reforms, Keynes said, that economists can be the trustees of 'the possibilities of civilisation'.

The ideas of Keynes, reinterpreted in a mechanistic form in an effort to make them compatible with neoclassical theory, became the basis for a new orthodoxy during the three decades after World War II. This was the age of 'neoclassical synthesis': an uneasy blend of the 'interventionist' ideas of Keynes with the 'free-market' theory of the neoclassical economists. It coincided with the years of the long boom when, for the advanced industrial capitalist nations at least, there indeed did seem to be continuous economic growth and full employment. The collapse of that long boom in the 1970s ushered in a major assault on Keynesian economics, both in theory and in policy practice. Western capitalism saw the impact of a resurgent pre-Keynesianism, known as monetarism, which argued that capitalism would work best when government 'interfered' least.

Monetarism has been associated with a general revival in the last three decades of various forms of 'free-market' economics. The ideas of Adam Smith are blended with propositions from neoclassical theory and other contemporary 'New Right' theorists (in the process setting aside Smith's reservations about markets and businessmen, and overlooking the fundamental differences between capitalism in his time and ours) to show the benefits of releasing capitalism from the constraints imposed by trade unions and states.

Modern political economists usually express profound reservations about the ascendancy of this neo-liberal 'free-market' economics. They argue that it fails to provide a coherent means of understanding contemporary capitalism, and that its policy prescriptions accentuate economic inequality, instability, and insecurity in practice. They put the case for drawing on the dissident traditions of Marxist economics, institutional economics, and the political economics of Keynes, and for building a more critical analysis of capitalism that takes account of contemporary economic problems (as reviewed in chapter 4).
This, in a nutshell, is the story of the competing schools of economic thought. It is the story of ongoing rivalry—partly methodological and partly political in character—within this contested but highly influential discipline. It illustrates the controversial character of economic ideas about capitalism over more than two centuries.

Have we come a long way? Or are there elements of circularity, repetition, and regress in the development of economic thought? Has the inherently political nature of economics impeded our understanding of capitalism? And, on what basis can future progress be made, both in understanding the economic system and in changing it for the better? A prerequisite for such progress is understanding how we reached this point. That, essentially, is the rationale for studying political economic analysis in historical perspective. It is the rationale for much of what follows in the rest of this book. This is not a matter of studying the history of economic thought for its own sake, but of doing so in a selective, illustrative manner in order to tease out what is of continuing relevance to understanding and resolving economic problems today.  

CONCLUSION

Identifying the key processes that shape the functioning of the capitalist economic system, for better or worse, is the key concern of political economy. Even the interpretation of the economy as a ‘system’ implies some such analytical stance: ‘system’ implies regularities of behaviour, forces that impose order on the outcomes, and systemic features that, in principle at least, can be understood and then controlled.

However, there is no unanimity on how to fashion this understanding. Rather, it is evident that an economic system like capitalism can be understood in various ways. Those different ‘ways of seeing’ exist partly because of methodological differences regarding theory-construction and partly because of differences in value judgments associated with rival political philosophies. Moreover, as a historical analysis of the discipline reveals, there is a strong connection between the contest of economic ideas and the conflict of economic interests.
PART III

Back to Basics
Classical political economy
CHAPTER 8

Capitalism Emerging

A ‘natural’ order?

Do the concerns of the classical political economists still matter?
What processes produced the economic system that the classical political economists sought to understand?
Why did they see the emerging capitalist system as progressive?

Classical political economy spanned the period from the mid-eighteenth century to the late nineteenth century. During this period significant contributions to economic theory were made by Adam Smith, David Ricardo, Thomas Malthus, Jean-Baptiste Say, James Mill, John Stuart Mill and many others. Most of these scholars came from relatively privileged backgrounds: the conditions of ordinary working men and women permitted no comparable opportunities for leisured study, publication, and social influence.

Why should we be interested now in the ideas of these dead white males? Surely, theirs was a different society, with different economic characteristics and problems. It would be unreasonable to claim that their analyses can simply be applied today without substantial revision. However, some familiarity with their contributions is useful for at least three reasons. First, it is interesting in its own right to see how these practical scholars grappled with the workings of the emerging capitalist economy. Second, their work has had a major influence on subsequent economic thought; it is no exaggeration to say that the major traditions of economic analysis, both conservative and radical, are largely developments of, or reactions against, classical political economy. Modern political economy is, in important respects, an extension of this classical tradition. Third, the prescriptions of the classical political economists are of continuing influence on economic policies in the real world, notwithstanding the major economic changes that have taken place since the end of the nineteenth century.

THE CURRENT INFLUENCE OF CLASSICAL IDEAS

Many modern economic viewpoints are traceable to classical political economy. Adam Smith (1723–90) is often cited in support of the arguments for 'free-market' capitalism, for example. The belief that freedom of exchange and a self-regulating market are the preconditions for social progress is one of the hallmarks of 'New Right' ideology today. Promoted vigorously by so-called 'think-tanks', operating both nationally and internationally, this particular economic ideology has had widespread influence. It has had a
direct connection with the policies of influential politicians in the late twentieth century, such as former British prime minister Margaret Thatcher, former US presidents Ronald Reagan and George Bush, and contemporary Australian political leaders, such as John Howard. Their economic advisers, if not actually tie-wearing members of the ‘Adam Smith Club’, have been imbued with a preference for the ‘invisible hand’ of the market over the ‘visible hand’ of the state. This preference is revealed in the political rhetoric, if not in the economic policies actually implemented.

The ideas of David Ricardo (1772–1823), another of the leading classical political economists, are also of enduring significance. In his own day, Ricardo was a strong advocate of breaking down the barriers to international trade, arguing that, if each nation specialised in the production of the goods and services for which it was best suited and traded its surplus with other nations, all would benefit. This is the basis of his famous doctrine of *comparative advantage*. Proponents of globalisation today generally mount similar arguments—although the term ‘competitive advantage’ has replaced the Ricardian ‘comparative advantage’. A careful assessment of the case for and against tariff protection or other impediments to trade can usefully begin with a reconsideration of Ricardo’s reasoning.

Or take the case of Thomas Malthus (1766–1834), the ‘gloomy parson’ famous for his views on *population growth*. Malthus argued that there would be a persistent tendency for the rate of population growth to outstrip the rate of growth in food production, leading to famines, illness, and wars, and preventing the living standards of the mass of the population from rising substantially above subsistence level. There are strong echoes of such concerns in current debates about Third World poverty and the environmental constraints on economic growth. On a global scale, high birth rates and poverty remain strongly correlated, although there are grounds for believing that poverty causes high fertility, rather than *vice versa*. The distinguished economist Amartya Sen also argues that the Malthusian ‘food availability doctrine’ pays insufficient attention to the importance of political factors in explaining and resolving poverty; he contends that ‘no famine has ever taken place in the history of the world in a functioning democracy’. Most modern environmentalists, stressing the consequences of wasteful production and consumption and the problems arising from the maldistribution between rich and poor nations, do not adopt a Malthusian ‘doomsday perspective’ either. Some do, however: prominent American environmentalist Paul Ehrlich, for example, continues to argue that excessive population growth underpins the problems of poverty and environmental decay. Moreover, even those who argue that production and consumption levels, rather than population numbers *per se*, are the root problem tend to couch their concerns in terms of the stresses, and ultimate unsustainability, of growth.

A final illustration concerns the views of French classical political economist Jean-Baptiste Say (1767–1832). He is best known for what has come to be called ‘Say’s Law’. This, in a nutshell, is the proposition that *supply creates its own demand*. Thus, the production of goods and services can be expected to generate the income that is necessary to purchase those commodities. Hence, there need be no general tendency towards economic recession arising from a shortage of demand. Underconsumption need never be a problem, according to this view. Although the modern
'free-market' economists seldom explicitly cite Say's Law in support of their prescriptions, the legacy lives. Milton Friedman, for example, has repeatedly argued that a capitalist economy tends towards its own stable equilibrium, and that government 'intervention' intended to offset recessions by boosting the level of demand is likely to do more harm than good.

**Box 8.1**

**Adam Smith (1723–90)**

The outstanding figure in classical political economy was actually a professor of moral philosophy. The study of economic issues was not then separated from the broader study of society—its historical evolution and the political ramifications of change. The ethical aspects of economic behaviour were regarded as being of paramount importance.

Adam Smith was born in Scotland in 1723. He spent six years in England as a student at Oxford University, where, as one biographer notes, he 'was dismayed by the low level of intellectual activity and the immorality of his fellow students'. He had a pretty low opinion of the professors, too, and he reflected on the question of whether they might be more productive if they were paid according to their performance.

After returning to Scotland he secured a teaching position at the University of Glasgow, before being appointed to the chair of Moral Philosophy. In 1759, he published an important treatise entitled *The Theory of Moral Sentiments*. However, it was the publication in 1776 of *An Inquiry into the Nature and Causes of the Wealth of Nations* (usually known simply as *The Wealth of Nations*) that really made his name as the leading political economist of the time. With *The Wealth of Nations*, Smith laid the foundation for the systematic study of political economy. Here, indeed, was an intriguing blend of political judgments, philosophical reflections, and practical observations about commercial activities.

Smith wrote *The Wealth of Nations* after resigning from his professorship to take up a lucrative post as personal tutor to a young nobleman travelling in Europe. (He revealed in *The Wealth of Nations* that he was personally quite sceptical of the educational value of extended continental tours for young men.) Later, he held the office of Comptroller of Customs for Scotland, in which capacity he managed the tariffs on imported goods. Smith, although committed to a belief in the progressive role of markets, was clearly a pragmatist. His support for the principles of a market economy was conditional and hedged by ethical concerns. He may well be 'turning in his grave' at some of the extreme *laissez-faire* ideological positions taken by his modern followers, including some who proudly wear the tie of the 'Adam Smith Club'.

The ideas of classical political economists are strikingly—almost eerily—relevant to current debates about market freedoms, the benefits of trade, population growth, recessions, and the appropriate role of government. But are they helpful? They were
developed to understand an economic environment quite different from today's. So, in considering the applicability of this intellectual legacy, it is pertinent to consider the historical context in which the ideas originally developed.

THE EMERGENCE OF CAPITALISM FROM FEUDALISM

The classical political economists were writing at a time when one economic and social order was being replaced by another. Indeed, whether it did actually constitute a new order was a fundamental concern. Smith, Ricardo, Malthus, and Say were observing a dramatic historical transformation that was to culminate in capitalism becoming the predominant economic system. It did not occur overnight, nor even over a few decades: it was a process that evolved over many centuries. It was the culmination of changes in patterns of economic production and class relationships that had been taking place in Europe from about the eleventh century onwards. By the sixteenth century, the rate of change had accelerated, making that century in particular the watershed between the old, decaying feudal order and the new, rising capitalist system. From then, up to the nineteenth century, the 'great transformation' occurred. Many scholarly works have been written about the nature of this transformation. For our purposes, it will suffice to list some of the key elements in this interconnected process of transformation, focusing particularly on the historical conditions in Great Britain, where the capitalist system first took clear shape before it became well developed elsewhere in Europe, was 'exported' to the colonies, and became global in form.

1. Improvements in agricultural technology were a particularly important foundation. People usually think of capitalism as being an urban, industrial economic system, so it is pertinent to note that its origins were rural. Only when a society can meet its own food requirements without expending all its labour continuously on producing food do other forms of economic development—urban and industrial—become possible. Such potential was already being realised by the eleventh century. A key contributor was crop-rotation (leaving a third of the acreage fallow each year so that the soil’s nutrients could be restored), which resulted in higher yields. And horses came to replace oxen as the principal sources of traction, enabling more efficient ploughing. Some degree of rural and urban specialisation became possible because of the greater productivity that these changes brought.

2. The creation of an agricultural surplus facilitated the growth of towns. No longer did all the people need to work on the land in order to subsist. Before the tenth century, there had been only a few small trade centres among the scattering of villages, but significant towns—albeit still tiny by modern metropolitan standards—were well established by the thirteenth century. The towns that developed in this period can be regarded as the cradles of capitalism; however, this was primarily a merchant capitalism rather than an industrial capitalism. Craft production was a characteristic economic activity, involving the manufacture of items for both local consumption and, increasingly, trade.

3. The development of long-distance trade opened up further opportunities for commodity exchange. Even by modern standards, some of this trade involved quite prodigious distances. The Venetian trader Marco Polo traversed Asia in the thirteenth century,
for example. By that time, annual trade-fairs, often lasting several weeks, were flourishing in Europe. From about the fifteenth century, fairs were starting to be replaced by permanent commercial centres located in cities and had increasingly sophisticated systems of currency exchange and credit facilities. These places were, in effect, embryos of modern financial centres. They laid the foundations for commercial law, gradually supplementing and then replacing the customary laws that formerly prevailed. This is a reminder that capitalism is not a 'natural' order that develops in a vacuum: it depends on certain social preconditions, including legal structures relating to contractual arrangements and property rights.

- These economic and social developments accelerated the decline of the manorial system. Feudalism was essentially a localised rural economic and social system based on individual manors, each ruled by a lord. This manorial system, the 'bastion of feudalism', was vulnerable to the spread of monetary exchange relationships. The growth of towns and the growth of trade between rural manors and cities began to erode the autonomy and self-sufficiency of the manors. The lords of the manors purchased luxury goods from urban merchants, and peasants supplemented their subsistence livelihood by selling some of their produce at local markets. Production for profit, and monetary relations in general, began to replace the customary relationships on which the manors had traditionally been based.

- Meanwhile, the putting-out system was developing. This was a production system in which craftsmen were contracted to manufacture items directly for merchant-capitalists. These merchants typically provided the raw materials and the craftsmen made the products in their own homes, selling them directly to the merchants for a fee. These arrangements, well developed by the sixteenth century, were a forerunner of capitalist industry. The putting-out system was not itself fully capitalist. The workers worked in their own homes, not under the direct supervision of employers, and, significantly, their labour was not wage-labour—they were remunerated for the products made. However, the system can be regarded as paving the way for capitalist employment. The putting-out system persists in many sectors of modern industry—as 'outwork' in the clothing industry, for example. Indeed, it has become increasingly widespread in computer-based service industries (such as desktop publishing), which seem to be developing the characteristics of modern 'hi-tech cottage industries'.

- For there to be a fully fledged industrial capitalism, a working class had to be created. Peasants and artisans had to be severed from their traditional livelihoods in order to create pools of wage-labour. The enclosure movement was a particularly important means to that end—although its immediate motivation was acquiring profits through the privatisation of land. During the eighteenth century, more and more common land—land on which peasants had traditionally grazed their livestock—was fenced off, especially for sheep-grazing to produce wool for the expanding textile industry. This accelerated a process of rural-urban migration that had already started in the fifteenth and sixteenth centuries. Peasants, driven from their villages because they no longer had the means to support themselves, frequently became vagrant and moved to the towns in search of whatever livelihood they could eke out. They were the raw material for the development of an urban industrial working class.
Improvements in transportation and production technologies, culminating in the ‘industrial revolution’, were the final piece in this jigsaw of forces precipitating social change. Improvements in transportation technologies had been taking place over a long period of time. Bigger and better sailing ships, and improved navigational aids facilitated trade and the establishment of colonies, such as those in the Americas and the Antipodes. A great burst of technological innovation in the eighteenth and nineteenth century led to dramatic advances in the production of textiles, in coal mining, and in the forging of iron and steel. The development of the steam engine was a great leap forward, both for industrial production and rail transport. These industrial changes took place in a socioeconomic context where the foundations for capitalism had already been established. They provided unstoppable momentum.

**A Desirable Transformation?**

The transition from feudalism to capitalism involved changes in class structures, in spatial form, in technological conditions, and in patterns of trade that provided the necessary and sufficient material conditions for the new economic and social order. These dramatic changes in material economic conditions were accompanied—as dramatic economic changes usually are—by corresponding changes in prevailing ideas. Indeed, some scholars have argued that it was the widespread acceptance of particular ideas conducive to acquisitiveness and material progress that explains why capitalism first took root in Great Britain and then in Europe. The Protestant strain of Christianity is often described as providing the accommodating ideology, making the pursuit of personal wealth no obstacle to getting to heaven. But the economic changes themselves precipitated further ideological changes. It was in the context of this great transformation that classical political economy emerged.

The transformation was neither smooth nor uncontested. The erosion of feudal arrangements created considerable insecurity and generated much social conflict. Major changes to traditional economic and social structures always create winners and losers; the latter can always be expected to resist. So it was with the changes just described: peasants’ revolts were common from the fourteenth to sixteenth centuries; there was bitter resistance to the enclosure movement; some workers, feeling their working conditions threatened by the introduction of new machinery and managerial techniques, formed significant resistance movements, most famously the Luddites; and agricultural workers who sought to form themselves into a union to protect their wages and working conditions were found guilty under the Mutiny Act and ‘transported’ to Australia (before public protest succeeded in pressuring the authorities to allow them to return from that dreadful place).

Concerns about the ethical aspects of the transformation to capitalism were also widespread. Would it be a stable economic system? Would it serve society well? Many churchmen worried about the primacy afforded the quest for profit, and the implications of putting individual self-interest before social responsibility in economic affairs. It was in assuaging such concerns that classical political economy made its great ideological contribution.
CONCLUSION

Classical political economy developed in the context of a great historical transformation. Although the concerns, analyses, and prescriptions of the classical political economists were diverse, we can see them as being essentially concerned with understanding the emerging socioeconomic system that eventually came to be known as capitalism. They did not see it as a blessing for all humankind, but their teachings generally served as a supporting ideology for the new system. By inference, it was a 'natural' order, compared with which previous systems of economic organisation were underdeveloped precursors.

The class relationships, social customs, and moral beliefs of the feudal era persisted into the age of classical political economy. Disquiet about the ethical implications of embracing a capitalist economy was common. So, there is something rather ironic about taking the analyses developed by classical political economists directly into the modern context, particularly when those ideas are used to justify the extension of capitalist, 'free-market' principles. Nevertheless, as this chapter has argued, there are some significant elements of continuity between the age of classical political economy and today, both in the way capitalist development is interpreted and in the associated dilemmas—moral as well as material. The classical political economic concerns have strong contemporary echoes.
CHAPTER 9

Private Vices and Public Virtues

What beliefs about society underpinned classical political economy?

What are the ethics of relying on self-interest as the driver of economic activity?

Do these 'liberal' economic ideas provide a strong case for an unregulated market economy?

Is capitalism a progressive economic system, contributing to our capacity to achieve social progress? From the time of the classical political economists, this has been a contentious issue. Adam Smith and the other leading intellectuals of the day were essentially concerned with ethical issues, seeing dangers in the breakdown of the old social order as well as the opportunities being opened up by the new. They established the basic principles of economic liberalism, on which most subsequent pro-capitalist ideology has been constructed. They thereby built a strong case for the market economy, reassuring the dominant classes that it could be an engine for substantial material progress. However, significant reservations were expressed about its social effects and whether it would benefit the mass of the people. Because of the strong influence of these ideas—particularly on neo-liberal views and policies today—they warrant consideration in the context in which they were developed.

CHALLENGING MERCANTILISM

The ideas of the classical political economists were, first and foremost, a challenge to the prevailing practices and beliefs of mercantilism. Mercantilist doctrines were influential in the seventeenth and eighteenth centuries. The prevailing view was that national economic progress required a major role for government in managing national economies and regulating trade. A particular focus was on the need for policies to stimulate exports and minimise imports, thereby ensuring an inflow of gold that would increase the supply of money—and by implication the total wealth—in the national economy. The mercantilist regime saw governments granting major monopolistic privileges to the big financial and trading companies in order to promote this goal. Understandably, these state-sponsored businessmen had a vested interest in preserving the existing economic arrangements.

However, mercantilism had its increasingly influential opponents. Small business people and farmers generally resented the monopolistic privileges accorded to the big trading houses. The taxes levied in order to finance the national powers—economic, political, and military—also created resentment, especially in the colonies. The claim for 'no taxation without representation' was one of the central themes of the War of American Independence (1775–83). This resentment against mercantilism,
together with the growing interest in liberal economic ideas, such as those promulgated by Smith, began to bode ill for the old order. The classical political economists’ call for freedom of the market place had growing appeal, particularly to the emergent capitalist class.

CHALLENGING THE CHRISTIAN CORPORATE ETHIC

There was also a striking clash in the eighteenth and early nineteenth centuries between the new economic ideas and the values and interests associated with the old order. The clash was not only with the elements of the state and the businesses wedded to mercantilism, but also with the medieval social and religious institutions. It was a period of considerable uncertainty and grave disquiet about what the future held in store. It was ‘an era in which an outdated economic ideology, the Medieval version of the Christian corporate ethic, came into increasingly sharp conflict with a new social and economic order with which it was incompatible’.1

The old order had been based on explicit ethical principles. This ‘Christian corporate ethic’ accepted private property and enterprise as a basis for economic activity, but saw it as a means of generating wealth to support charitable acts. ‘The rich man, if he does not give alms, is a thief’ was one common view.2 A benevolent paternalism was expected of the upper classes. Greed, selfishness, and covetousness were reviled and denounced. Merchants were regarded as being morally bound to trade at a ‘just price’ (admittedly an ill-defined concept, but one sharply at odds with the temptation to charge ‘whatever the market would bear’).

By contrast, the new order seemed to require fewer constraints to be imposed on business activity. Altruism was no longer considered necessary for socially beneficial outcomes: self-interest would suffice, indeed would be the key driving force for economic progress. As E.K. Hunt puts it, ‘the sins that were most strongly denounced within the context of the Christian paternalistic ethic were to become the behavioural assumptions on which the capitalist market economy was to be based’.3

Therein lies a tension that has existed in right-wing politics ever since. On the one hand, the so-called ‘Tory’ tradition emphasises the paternalistic obligations of the economically well-to-do, the value of charitable works, and the need for the state to engage in economic and social regulation in order to achieve social cohesion; while on the other hand the right-wing ‘libertarian’ view has a fundamental antipathy towards the state and a greater confidence in the capacity of competitive markets to reconcile conflicting interests and ensure efficient economic outcomes, thereby making social policy less necessary. These are the familiar ‘wet’ and ‘dry’ factional positions in modern conservative political parties.

Did the classical political economists have more in common with the ‘wets’ or the ‘dries’? Adam Smith’s position shows the tension. He saw social and economic order arising from people’s natural desire to better their lot in life and thereby gain social esteem; however, he strongly emphasised the social context in which acquisitiveness occurs. His was not the crude ‘greed is good’ position sometimes espoused by his modern ‘dry’ disciples. Indeed, Smith, the moral philosopher, had argued in his first major work, The Theory of Moral Sentiments, that society is not held together merely by neutral rules: sympathy for the plight of our neighbours is important
because it leads to a sharing of emotions and sensations. Given these preconditions, he argued, self-interest can then be of positive economic benefit. It is a conclusion summed up in his oft-quoted statement in *The Wealth of Nations* that, 'It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest'.

Here is the classical political economist's case for the market as the means by which self-interest can be harnessed for social purposes. Smith's great ideological achievement was to show that a new social order could emerge out of the potential chaos of an individualistic society. In his own words:

Each producer intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not a part of it. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need to be employed in dissuading them from it.

The phrase 'invisible hand' is rather buried in this quotation. However, it has come to symbolise Smith's intellectual legacy, providing the classical argument for a free-market economy. If reliance on the 'invisible hand' is sufficient basis for a thriving economy, no further economic planning or political intervention seems warranted. It is pertinent to note, however, that although the notion of an 'invisible hand' implies a general preference for self-regulating markets, Smith saw those markets as requiring social foundations that would shape behaviour in desirable ways. There is an explicitly ethical dimension to the reasoning: there is an inference that the invisible hand may, after all, be the hand of God.

**ECONOMIC LIBERALISM**

In putting the case for the greater individual freedom of the market place, Smith was in agreement with a number of other leading intellectuals of the eighteenth century. A particularly intriguing contribution to the debate had been published some decades earlier, in 1704. Written by Bernard Mandeville and entitled *The Fable of the Bees*, it was a bestseller. It is a strange book; it begins with a poem and continues with a number of essays and dialogues. The central theme is how 'private vices' (such as self-interest) can lead to 'public benefits' (the better operation of the society as a whole); thus, Mandeville argued, individual human actions spontaneously generate orderly social structures like law, language, the growth of knowledge, and, yes, the market. Selfishness, because of its association with industriousness, would thereby tend to contribute to a thriving economy.

Similar views came from many intellectuals of the age. Collectively, this was a crusade for liberty. The emphasis on the freedom of the individual was married to assertions about the need for freedom of trade. It produced an ideology markedly favourable to the ascendency of capitalist values and practices. It helped sound the
death knell of mercantilist doctrines, if not of all mercantilist policies in practice. Moreover, it fitted in with the Protestant theology that emerged from the Reformation—a set of religious beliefs largely free of the moral opprobrium that the Catholic church had heaped on commercial activities. Protestantism held that people would be judged by their faith rather than their works, so a pure heart and faith in God could be quite compatible with acquisitive economic behaviour. Wryly, one might say that a businessman looking into his conscience could readily find 'that God had planted there a deep respect for the principles of private property'.

Economic liberalism draws these ideas together. It is not altogether compatible with liberal philosophy in general, but provides a particular view of the relationship between people's essential nature and their economic activities. Somewhat schematically, we may identify its four interrelated assumptions as follows:

- **individualism**: the individual is regarded as the basic unit of society; consequently, no sound claim can be made about any social interest that purports to be more than, or different from, the aggregation of individual interests
- **hedonism**: individuals are driven by self-interest, seeking pleasure and avoiding pain
- **rationality**: the pursuit of self-interest takes a deliberate form, each individual weighing up the costs and benefits of alternative courses of action and choosing that which promises him or her the most advantageous outcome
- **inertia**: people are basically lazy, remaining inactive unless motivated to action by the prospect of personal gain.

If we regard people in this way, it is not difficult to see why the market is held to be a desirable arrangement for dealing with economic matters. Individual preferences for goods and services can be expressed in the market place, sending signals to the producers about what is wanted and what is not. Sellers compete with one another to supply the products to meet the demand, and that process of competition keeps prices at a minimum. Not all individual aspirations are necessarily met, but the market mediates between all the individuals to achieve effective compromises. Mutually advantageous exchanges occur. Economic resources are efficiently used.

**ON THE OTHER HAND ...**

Although classical political economy—and the tradition of economic liberalism that it spawned—played a key role in legitimising capitalist market relationships, the classical political economists themselves expressed significant reservations. Adam Smith was certainly no apologist for capitalist business practices in general. Smith's 'ambivalence towards nascent capitalism' is evident from a careful reading of his work. A deep suspicion is evident, for example, in his observation that 'people of the same trade seldom meet together ... but the conversation ends in a conspiracy against the public or in some contrivance to raise prices'. What he favoured was a process of competition in the market to limit such anti-social business behaviour.

It is also important to note that, although Smith was unsympathetic to governments wielding great economic power, his was not a simple advocacy of laissez-faire. In the lectures on jurisprudence that he delivered at the University of Glasgow he argued that the chief purpose of government is to preserve justice, and that this would require the state to protect the individual's personal rights, property, reputation, and
social relations. In *The Wealth of Nations* he argued that government must carry out important functions in providing defence against foreign invaders, maintaining public institutions (such as those providing for transport, education, and religion), and protecting citizens against injustices suffered at the hands of other citizens.

Nor was Smith in favour of greater economic inequality. By the general standards of the time, an egalitarian sentiment can be discerned in his writing. His was a vision of society in which all people would be making their personal contributions to economic advancement. In his own words, economic progress would stem from ‘the uniform, constant and uninterrupted effort of every man to better his condition’. It would be from the grass-roots effort of the great mass of people, rather than from particular leaders of business of finance, that economic progress would emanate.

It must be borne in mind that Smith was writing about a very different economy from today’s. The businesses were usually tiny by modern standards. What Smith saw as desirable was competition, not capitalism *per se*. He was an opponent, first and foremost, of monopoly. He favoured markets, but saw an important role for government. He emphasised the need to have individual incentives, but did not support increased economic inequality. His views helped to undermine the Christian corporate ethic, but he was deeply concerned about the moral dimension of economic behaviour; as political economist Robert Heilbroner notes, ‘Smith was by no means oblivious to the moral costs of acquisitiveness’. These are the reasons why the attempt by modern neo-liberals to claim descent from Adam Smith is so problematic. To quote Heilbroner again: ‘In Smith’s hands the interplay of market forces and moral decline takes the form of a subtle dialectic that invests his work with its remarkable depths. In the hands of his successors the dialectic disappears, and the evaluation of economic growth emphasises its material aspects without any concern as to untoward moral consequences, in terms of either motives or social outcomes’.

**CONCLUSION**

Classical political economy provides the basis on which subsequent economic thought has developed. It challenged prevailing mercantilist beliefs about what constituted ordered arrangements of economic activity and social progress. It established economic liberalism as the dominant economic outlook, building on existing views about individualism and acquisitiveness. It flourished in a time when the Christian corporate ethic was starting to be eroded. It seemed to be the ‘modern’ way of understanding economic activity.

In any period of rapid economic and social change there are always anxieties and tensions. Today, for example, we find a former academic supporter of the ‘New Right’ warning against further moves towards globalisation and neo-liberalism: ‘a deepening international anarchy is the human prospect’, says John Gray. Taking a longer-term perspective, another recent reviewer of our experience of economic progress warns that ‘the essential balance between the collectivist and individualist traditions that has existed for most of the last two hundred years may have been a historical accident ... only possible during the transitional phase between the religious pre-capitalist era and the secular capitalist age. If that is so, the prospects for continued human progress are bleak indeed’.
Box 9.1

The Irish potato famine

In the period 1845–49, a disaster befell Ireland. The potato crop, the staple of the Irish peasants’ diet, failed in many parts of the country. Disease caused the potatoes to rot in the ground before they had ripened. What to do about this appalling situation was a major concern for the political leadership in London. In this context, classical political economy wielded awesome influence. The British leaders had the capacity to resolve, or at least ameliorate, the Irish crisis by arranging for the supply of food from other sources. However, as the historian Cecil Woodham-Smith notes, their actions (or rather, their inactions) were shaped by a belief in an economic theory that almost every politician of the day held to with religious fervour.

This theory, usually termed laissez-faire, insisted that individuals should be allowed to pursue their own economic interests, and that governments should interfere as little as possible. Not only were the rights of property sacred; private enterprise was revered and respected and given almost complete liberty, and on this theory, which incidentally gave the employer and the landlord freedom to exploit his fellow men, the prosperity of nineteenth-century England had unquestionably been based.

The influence of laissez-faire on the treatment of Ireland during the famine is impossible to exaggerate. Almost without exception, the high officials and politicians responsible for Ireland were fervent believers in non-interference by Government, and the behaviour of the British authorities only becomes explicable when their fanatical belief in private enterprise and their suspicions of any action which might be considered Government intervention are borne in mind.

The loss of the potato crop was therefore to be made good, without Government interference, by the operations of private enterprise and private firms, using the normal channels of commerce. The Government was not to appear in food markets as a buyer, there was to be ‘no disturbance of the ordinary course of trade’ and ‘no complaints from private traders’ on account of Government competition.15

Shops and organisations for importing foodstuffs and distributing them were generally found only in prosperous districts of Ireland: in Ulster in the northeast, in Dublin, and in some places in eastern Ireland, including the larger towns like Cork. In the places where relief would be most needed, in the west and southwest of Ireland, the means by which it could be distributed rarely existed. It is estimated that over a million people died in the famine, and a further million emigrated because of it. Some joined the flow of emigrants to Australia; many more went to the United States. It was an tragic result of laissez-faire economics.

In Britain during the late eighteenth and nineteenth centuries the ideas of classical political economy were widely influential—for better or for worse. As capitalism developed in other nations and their colonies these ideas became yet more widespread. Classical political economy reassured sceptics of an earlier
era that an economy based on individual enterprise and markets would not result in chaos. Here were arguments showing that the greater freedoms of the market place would produce a healthier economy and more progressive society. However, the leading classical political economists, most notably Adam Smith, were well aware of the need to qualify the general case for *laissez-faire* with observations about the dangers of monopoly and the need for good government. While it is important to interpret these views in their historical context, it is also necessary to be wary about their application, *carte blanche*, to modern capitalism.
CHAPTER 10
Value, Distribution, Growth

What, according to the classical political economists, determines the value of goods and services?
What shapes the distribution of income?
What conditions are conducive to economic growth?

As discussed in the previous chapter, classical political economy has had a powerful ideological influence. A vulgarised version of it can be used to support the case for an economic system based on individual initiative and market organisation. Its more sophisticated aspects raise fundamental questions about the ethics, and the social foundations, of commercial enterprise. These ethical and philosophical aspects of classical political economy are of central importance in assessing its role as capitalist ideology. However, the classical political economists were also deeply concerned with the construction of economic analysis. It is to this aspect that we now turn.

What were the main analytical concerns of classical political economy that flow through into modern economic analysis? It is difficult to provide a summary because significant points of difference separated the leading scholars, such as Smith, Ricardo, Malthus, and Mill. For our purposes here, it is sufficient to identify three themes: value, distribution, and growth. These are fundamental to the capitalist economy—indeed to understanding any type of economic system. What is the value of a commodity and how is it determined? What economic forces shape the distribution of income among the members of a society? How is economic growth generated and what may sometimes cause it to stall? This trilogy of concerns has been central to economic analysis ever since.

VALUE

What determines the value of different goods and services? You may have personally pondered this issue as you survey supermarket shelves or wonder whether you can afford a particular purchase. Why do different brands of car have the prices they do? What determines the relative prices of a cup of coffee and a bar of chocolate? Is the ‘value’ of something purely a question of its market price? Or, does it reflect some innate characteristic of the product—some personal evaluation of its usefulness or measure of its intrinsic social worth? Philosophical issues mingle with more down-to-earth, empirical issues in such deliberations.

As a broad generalisation, we can identify three contributions to the analysis of value stemming from the works of the classical political economists. First is the distinction between value in use and value in exchange. The water–diamonds paradox is
the standard illustration. Water has more value in use than do diamonds: it is an essential item, necessary for life itself; diamonds, however, are a luxury item with much more limited uses. But diamonds have the higher value in exchange: their market price by weight or volume is far higher than water's. The obvious explanation for this divergence between usefulness and market price is the differences in supply conditions between the two goods: water is plentiful and needs little labour to make it available for consumption, while diamonds are scarce and take a great deal of effort (prospecting, mining, cutting, and polishing) to make them available. According to classical political economy, these supply conditions are crucial in shaping exchange values.

The second proposition follows from this. Broadly speaking, the value of a commodity reflects its cost of production. Where labour is the sole or principal cost this means that exchange values depend on the amount of labour expended. As Adam Smith said, 'if, among a nation of hunters, it usually costs twice the labour to kill a beaver which it does to kill a deer, one beaver should naturally exchange for, or be worth, two deer'.1 It seems natural that what is usually the produce of two days' labour should be worth double the produce of one day's labour. This is the essence of the labour theory of value, which Karl Marx was later to develop into his critique of capitalism. For the classical political economists its more limited role was in explaining the relative prices of different goods and services. It was recognised that scarcity can affect value in exchange, but the main emphasis was on the cost of production of the items in question.

Third, the classical political economists' approach emphasised the 'natural price' of each product. This is its innate value. It is not necessarily its actual market price at any particular time. It is a sort of long-term equilibrium price around which day-to-day changes in the market price can be expected to fluctuate. If the actual market price is above the 'natural price' for any significant period of time (because of the scarcity of the item in question, for instance), this will induce the entry of new firms into the market to supply the item, and thereby cause the market price to fall. If the actual market price is below the 'natural price' (because of temporary overproduction relative to demand, say), firms will leave the industry, the glut will be eradicated, and the market price will rise; thus, in the longer term, the 'natural price' tends to prevail.

These three propositions—about the distinction between use values and exchange values, the role of labour in the determination of value, and the character of 'natural prices'—have given rise to a wide range of subsequent developments. The radical twist given by Marx to the labour theory of value, for example, stands in striking contrast to the neoclassical economists' attempt to refocus the explanation of prices on scarcity and use values. Thus, a common foundation in classical political economy underpins rival views about capitalist exploitation and price determination according to supply and demand. What has dropped out of the picture along the way is the notion of 'natural price'. Even more striking is the abandonment of any concern with a 'just price'. In this respect, the attempts by classical political economists to develop a theory of value can be considered as marking a transition from traditional concerns with ethical aspects of commodity exchange to modern attempts to refashion economics on a more 'scientific' basis.
What determines the *distribution of income and wealth* within a society? This second concern may be regarded as even more fundamental than the first. Ever since the classical political economists focused attention on the question, it has commanded constant attention. One should hardly be surprised. The question ‘who gets what?’ is inherently contentious in any society. Under what circumstances will one individual, or a social class, receive the bulk of the income? Under what circumstances can more equitable outcomes be expected? Is it better to have even or uneven distributional outcomes? According to which criteria? Such questions are among the most politically sensitive issues in economic enquiry.

David Ricardo, who provided perhaps the most notable of the classical political economists’ contributions to this topic, considered the distribution of income among the classes to be ‘the principal problem in political economy.’ Among the classes is a key phrase here. For simplicity, it is useful to distinguish three such classes and the characteristically different type of income each receives: (1) capitalists, who receive profit; (2) landowners, who receive rent; and (3) workers, who receive wages.

These are classes of real people, not inanimate ‘factors of production’. What would determine their relative standards of living? Separate explanations of each type of income were proffered.

*Profits* are identified as the incentive for business activity and the necessary condition for capital accumulation. Material acquisitiveness is an essential element here, driving the accumulation process. However, the capitalists’ economic function is not in amassing wealth for its own sake, but in ploughing profits back into further rounds of business activity in order to increase the value of the capital. Thus, making profits is the *raison d’être* of successful business enterprise. As noted in the preceding chapter, this is the positive face of self-interest, whereby the quest for profits contributes to economic prosperity and expansion. However, because profit is a surplus (that which is left over after wages have been paid to workers and rents to landowners), its magnitude crucially depends on the size of those other income claims

*Rent* is a payment to landowners, reflecting their capacity to capture part of the surplus. In the agricultural context, it is a type of income dependent on the difference between a piece of fertile land and a piece of land that is just worth cultivating.

As Adam Smith wrote, ‘as soon as land becomes private property, the landlord demands a share of almost all the produce which the labourer can either raise or collect from it. His rent makes the first deduction from the produce of the labour which is employed by the land’. The land is necessary for production, but the capacity of landlords to charge a rent for all land other than the most marginal means that the income available for workers and capitalists is correspondingly reduced. For capitalists, this means less capacity for capital accumulation; for workers, it means a reduced possibility of earning higher wages, compounding the forces causing their perpetual consignment to a subsistence standard of living.

*Wages*, according to classical political economists, would tend to be kept at the minimum level necessary for workers to reproduce themselves. Were wage increases to encroach on profits, the capital accumulation process would be impeded. So, if
workers could not significantly share in the economic surplus, they would have to remain at subsistence level. It was a gloomy prediction for the mass of society. It had its most depressing form in the famous doctrines of Thomas Malthus.

According to Malthus, population growth would keep the working class poor. If any rise in wage rates occurred, the population would increase, putting pressure on the capacity for food production, and driving living standards down to subsistence level. An equilibrium of sorts would be restored, but it would be a diabolical equilibrium of poverty or near-poverty. Population growth, the inexorable consequence of the 'passion between the sexes', would have the effect of consigning the masses to a life of poverty, despite economic growth. Because 'the power of population is infinitely greater than the power in the earth to produce subsistence for men', any attempt to raise wages would be self-defeating.  

Although highly controversial, the Malthusian view about population growth keeping wages to subsistence level formed the bedrock of classical political economic reasoning. By the same reasoning, any attempt to help the poor would also be self-defeating, since charity would encourage faster population growth and discourage productive effort. This was a very austere view, but Malthus evidently felt his austerity and pessimism to be driven by the logic of the situation. It certainly illustrates the 'freedom from extreme sentimentality', as E.R. Canterbury puts it, that characterises classical political economy.  

Overall, these reflections on what determined the distribution of income between the major classes reinforced the view of economic inequalities as inexorable. The classical political economists' concern with liberty did not imply equality. On the contrary, it was the existence, even the 'naturalness', of the class system that underpinned the different types of income and the necessary economic inequalities. John Stuart Mill (1806–73) thought that the inequalities could be redressed by political means without violating the economic principles of production. However, as now, most orthodox economists worried that significantly redistributive policies would impair economic efficiency.

Growth

The third issue addressed by classical political economists had more positive connotations. This is the question of what determines the possibility of economic growth. Like the questions of value and distribution, it is a conundrum that continues to be central to political economic deliberations to this day.

How are economic systems able to expand the production of goods and services and the total flows of income and wealth generated? What conditions are conducive to that expansion? What circumstances are likely to impede it, causing stagnation or even plunging the economy into depression? Is growth necessary, desirable, and sustainable in the longer term?

As with the theories of value and distribution, summarising the views of the classical political economists on these issues is not easy. There were marked differences between the various contributors. For simplicity, we can identify three main ideas: (1) the division of labour, (2) the expansion of trade, and (3) the accumulation of capital.
The division of labour is the foundation for growth, according to classical political economy. Smith was particularly emphatic about this, beginning The Wealth of Nations with the famous example of a pin factory in which production levels are increased many times over as a result of workers doing more specialised tasks. The higher output made possible by the complex division of labour would lead to higher profit, which could then lead to the purchase of more tools and equipment, further increasing the productive capacity of the enterprise. A virtuous cycle of expansion would ensue. It would not be virtuous in all respects, though; Smith had significant concerns about its implications for the nature of work itself. This is what we might now call the problem of worker alienation. In his own words, 'the man whose sole life is spent performing a few simple operations ... generally becomes as stupid and ignorant as it is possible for a human creature to become'. There was also the problem of the demand for the product. There would be no point in expanding pin production if there were no growth in the demand for pins. In general, Smith noted, the division of labour is limited by the extent of the market.

The expansion of trade would create the conditions for that increase in demand. This second element in the analysis of growth is closely linked to the doctrine of comparative advantage developed by Ricardo. This doctrine seeks to demonstrate that all countries can benefit economically by specialising in producing those items in which they have a relative cost advantage, and then trading with one another in those items. Consider the situation where two countries, A and B, can produce two commodities, X and Y. Even if country A can produce both X and Y more cheaply than B, the doctrine of comparative advantage says it should specialise in the one in which it has the greater relative cost advantage, leaving the production of the other to B. International trade will then be to mutual advantage.

Ricardo used the theory of comparative advantage to support the repeal of the Corn Laws, which restricted agricultural imports to the United Kingdom. Nowadays, the same doctrine is used to support the case for trade liberalisation, including the removal of tariffs imposed by national governments on imported goods. It warrants critical consideration. What is the situation, for example, if the transport costs involved in international trade substantially offset the benefits of lowered production costs? Or, to put a topical, environmental spin on the issue, what is the situation if scarce, non-renewable energy resources are used in that transportation process? And are there not benefits for a nation from having diversified industries (ensuring greater national self-reliance in wartime, for example, or a wider range of employment opportunities for local citizens) that need to be set against the gains from specialisation and trade? Such concerns are raised here to caution against the extension of comparative advantage theory to more complex modern situations where there may be sound reasons to restrict trade. From the vantage point of the United Kingdom in the nineteenth century, comparative advantage theory constituted a convenient rationale for national self-interest. Its status as a general rationale for free trade, however, is contentious, despite its widespread influence.7

What about the possibility of continued capital accumulation? As capitalism was establishing itself as the dominant economic system, many people worried that the
growth of productive capacity would outstrip the market demand for the products. With workers’ wages tending to be kept down to subsistence levels, as the classical political economists predicted, this was presumably an even more likely scenario. Would growth necessarily lead to a slump? The classic reassurance came from the Frenchman Jean-Baptiste Say. His argument (introduced in chapter 8) was that supply creates its own demand, so there was no need to fear any general tendency towards depression, at least not because of overproduction. To be sure, temporary overproduction could occur in any particular industry as a result of miscalculation by the producers, but this would be matched by shortages in another industry. A fall in the price of the product in the industry that overproduced and price rises in the industry that underproduced would quickly correct the imbalance.

Malthus was not so certain that a general glut was impossible, arguing that wages, because they are not the total cost of production, may not be sufficient to purchase all that is produced. If that causes prices to fall, the incentive to invest falls and a prolonged slump may ensue. Excessive savings could have a similar effect, reducing the demand for products and causing stagnation.

Ricardo disagreed, taking basically the same position as Say. He argued that lower wages are a cure for slumps, not a cause of it, because businesses will hire the idle workers with the capital created by savings. According to this reasoning, savings are not an end in themselves, but a means of generating capital in order to employ labour in production. The potential imbalance between savings and investment, which Keynes was later to emphasise, was disregarded. According to Galbraith, adherence to Say’s Law was ‘the prime test by which economists were distinguished from crackpots’ until Keynes challenged the classical orthodoxy.8

Did these doctrines paint a rosy picture for the prospects of capitalist development? At first sight it may seem so. The classical political economists’ emphasis on the benefits arising from the division of labour and the expansion of trade, and the general confidence that there need be no problem of overproduction, seemed to bode well for the future of capitalism, even though the workers in general could not expect a rise in material living standards.

However, the forecast for economic expansion was actually rather more pessimistic. Yes, the division of labour and the growth of trade would create conditions for prosperity, but this would also lead to population growth, requiring land that was less productive to be brought under cultivation. That would cause food prices to rise, and so the general level of wages, in money terms, would have to rise in order to ensure that workers continued to subsist. That rise in wages would reduce profits, slowing capital accumulation and economic growth.

Ricardo expected that this slowing of capital accumulation would result in a ‘stationary state’. Such a situation, John Stuart Mill subsequently argued, could be interpreted in a favourable light as the basis for a progressive society, in which people could turn their attention from mundane economic matters to higher cultural and artistic pursuits. In terms of the analysis developed in chapter 5 of this current book, it would presumably mean paying less attention to GDP and more to the social and environmental improvements that would show up in terms of the Genuine Progress Index. For Ricardo, the prospect of a stationary state was an undesirable
Box 10.1

John Stuart Mill (1806–73)

John Stuart Mill was widely regarded as the greatest political economist of his day and the successor to Smith and Ricardo. His magnum opus, Principles of Political Economy, was published in 1849 and remained the standard reference on the subject for the best part of half a century until displaced by Alfred Marshall’s Principles of Economics.

A child prodigy, Mill was said to have made ‘a complete survey of all there was to be known in the field of political economy’ when only thirteen years old, having already learnt Latin and Ancient Greek; mastered geometry, algebra and the differential calculus; written a Roman history, a history of Holland and an abridged version of the Ancient Universal History. His father, the historian and philosopher James Mill, had insisted on this childhood of extreme intellectualism, allowing no holidays ‘lest the habit of work should be broken and a taste for idleness acquired’.

The wonder is that Mill not only avoided being emotionally crippled by his upbringing, but also went on to be a notably humane man, combining the principles of political economy with ethical social concerns. He supported democratic reforms, and women’s rights in particular.

Mill’s political economy synthesised the classical ideas. However, he broke with other classical political economists in one key respect—by emphasising the malleability of income distribution. He argued that economic principles govern production, but that political choices can shape distribution; thus, once wealth has been produced, we can share it as we collectively choose, untrammelled by any absolute ‘laws’ of political economy. In his own words, ‘the distribution of wealth, therefore, depends on the laws and customs of society’. It is a matter of politics, not economics. This was the basis for a much more optimistic view of the prospects for humankind than was to be found in Malthus, in particular, and the work of the ‘dismal science’ of economics, in general.

Mill thought that reason would prevail in public affairs. Once the working classes understood the Malthusian problem of excessive growth in population causing food shortage, they would voluntarily regulate their numbers. Eventually the economy would reach a ‘stationary state’, in which there would be no more economic growth but plenty of scope for social betterment. The government would create a more equal society by taxing rents and inheritances.

Mill’s mild socialism had little in common with the revolutionary socialism that Marx propounded. As Heilbroner describes it, it was ‘a doctrine English to the core: gradualist, optimistic, realistic and devoid of radical overtones’. An echo of Mill’s views may be discerned today in the claim by orthodox economists that efficiency is an economic concern and equity a political concern. Unfortunately, this normally leads to the concern with equity being set aside. Mill would have been aghast at this modern tendency.
outcome, a situation in which the dynamics of economic growth were not able to operate. The pessimistic nature of this prognosis is reflected in Thomas Carlyle’s famous description of political economy as the ‘dismal science’.9

CONCLUSION

The classical political economists laid the foundation for understanding capitalist development. Their method of analysis was influenced by the prevailing ideas of the age. Isaac Newton’s pathbreaking work in physics is a case in point: the classical political economists were, in effect, seeking to do for the study of social phenomena what Newton had done for the study of the physical world. For this purpose, the economy could be likened to a clock: if one could only understand the mechanism, then one could understand the regularities in its working. Thus, the quest was to discover the laws of motion in economic life. In Newton’s theory, there was the law of gravity; in classical political economic theory, there was self-interest—the propulsive element in an essentially natural and progressive economic system.

The classical political economists, although constrained by this methodology, were holistic thinkers. Indeed, by the standards of most of their successors, they were indeed ‘gentlemen and scholars’. They did not artificially separate the study of economic phenomena from history, geography, politics, and the study of society in general. Modern political economy, as we shall see in later chapters, is partly an attempt to regain this position—to re-establish the discipline as an interdisciplinary mode of analysis concerned with the study of value, distribution, and growth, and the economic dimensions of social progress in general.

The view of the economy as a means of producing an economic surplus is central to this story. It was a key element in classical political economy, underpinning much of the theory summarised in this chapter. An economic surplus is the excess of the value of production over and above what is necessary merely to reproduce the economy. How it is generated, how it is distributed, and the purposes for which it is used are the key determinants of how the economy works. The concern to understand this economic surplus constitutes a further element of continuity between classical political economy and modern political economy, and a point of contrast with neoclassical economics, which has no place for any such analytical construct. Focusing on the generation and disposition of an economic surplus draws attention to the importance of the relationship between capital and labour as social classes. It also makes necessary the study of the role of land and rent in the economy.
CHAPTER 11

Capturing the Economic Surplus

The land question

Is land economically important?
Is the rent of land a drain on economic progress?
Should land rent be taxed?

The analysis of land has a rather shadowy presence in modern economics. In agricultural economics and natural resource economics it cannot be ignored, of course; elsewhere it tends to be treated either as a factor of production—on a par with labour and capital—or as part of the backdrop to the real economic action of production, distribution, and exchange. This marginalisation of the analysis of land was not always the case, however. In classical political economy, the analysis of land was a central concern.

Why the change? To some extent it may be explained by the different material economic conditions. Economic ‘modernisation’, particularly over the last century, has caused proportionately fewer people to be directly engaged in farming. Meanwhile, modern technologies have made more and more industries ‘footloose’, not tied to particular geographical locations. All economic and social activities necessarily involve the use of land in some way, but the modern economy in general seems less place-bound. However, the neglect of the distinctive role that land plays in the economy also has an ideological dimension—diverting attention from the economic and social consequences of private land-ownership. Therein lies a significant bias. Its redress requires some reconsideration of what the leading classical political economists had to say about land. It also requires attention be given to the radical variation on the theme of land-ownership in the writings and teaching of Henry George.

THE SIGNIFICANCE OF LAND IN DIFFERENT ECONOMIC SYSTEMS

From an ecological perspective, it is particularly important that the use of land be carefully considered—after all, land is fundamentally different from labour and capital because its supply is inherently limited. It is part of our natural resource endowment. Even from a narrowly economic perspective, it is clear that the availability, use, and productivity of land (both in rural and urban contexts) has a major bearing on the capacity for economic growth. From a broader social perspective, land is also special. Some of us enjoy roaming over publicly accessible tracts of land,
while others enjoy exclusive use of small parcels of it. Managing the tension between these public and private perspectives is a key issue for public policy. So, the institutions that shape the use of land are of fundamental economic, environmental, and social significance.

There are enormous differences in the ways in which land is allocated and used. Consider, first, the role of land in traditional aboriginal societies, like the Aboriginal peoples of Australia or the Native American peoples of North America. Land is integral to subsistence and to community: indeed, it is usually not seen as something separate from life itself. People exist through being in, and of, nature. The land provides the sustenance that makes life possible. The people may be regarded as its custodians, but it makes little sense to think of them 'owning' the land, either individually or collectively. They no more own the land than it 'owns' them. Land is simultaneously history, geography, and spirituality; it is not a marketable economic asset.

Under feudalism, land also has a crucial, but quite different, role. Command over the disposition of land is a defining feature of the economic and social order. A person's relationship to the land significantly defines his or her social standing. The privileged position of the ruling class depends on control of the large areas of land that they possess. They 'call the shots' because they control the key resource that enables them to capture the lion's share of the economic surplus. The mass of the people, on the other hand, are in a position of economic dependency and social subordination because their livelihood depends on their access to the land that they themselves do not own.

For the classical political economists, the emergence of capitalism from this feudal order needed to be understood. The transition involved a significant change in the distribution of economic power. It saw a switch from landowners being the dominant element in the ruling class to capitalists being the ascendant element—economically, if not socially and politically. The landowners still dominated Parliament, of course. Then, as now, the social and political dimensions of the changes in the composition of the ruling class lagged behind the economic changes.

So it was natural that, in order to understand the economic conditions of their age, the classical political economists should pay particular attention to questions about land—its ownership, how income is derived from it, and the size of that income relative to the incomes derived from labour and capital. Indeed, even before the age of classical political economy, the land question had been central to economic discourse. The French physiocrats had argued that land—a gift of nature—was the only real source of wealth because it enabled agriculture to generate a net product in excess of production costs.¹

RENT AS A BRAKE ON ECONOMIC PROGRESS?

Of the classical political economists, David Ricardo had perhaps the most well-developed analysis of the role of land in economic progress. Himself a landowner, Ricardo was nevertheless no apologist for the interests of the landowning class. On the contrary, he saw the capacity of landowners to obtain a major share in the economic surplus as an obstacle to economic development. According to Ricardo, the income that they derive in the form of rent comes from the incomes that would
otherwise go to capitalists and workers. In so far as it comes from the profit share in particular, rent impedes the process of capital accumulation and thus limits economic growth. It is an argument that needs careful consideration. It is of continuing significance, notwithstanding the greater interpenetration of land and capital ownership in modern capitalism.

Rent has to be carefully defined in this context. We are used to thinking of rent as a payment for the use of housing. We commonly talk of 'renting' a house or a flat (or, generally, any commodity for hire, such as a car or a floor-sanding machine). In that popular sense, we are talking of a payment for temporary access to, or use of, the property—a payment that buys a flow of services over a specified period of time. It is important to emphasise that, in the current context, rent is being used in a more specific sense. It refers only to a payment for land: in other words, it is a site rent. What we normally call the rent for a house can be seen as having two components: the site rent for the land and the payment for hiring the house that stands on the land. Only the first of these two components can properly be called rent for the purposes of the current analysis. Defining rent in this way immediately draws attention to its class character—its association with the wealth and power of landowners.

According to Ricardo, 'the interest of the landlord is always opposed to the interest of every other class in the community.' Why is this so? The Ricardian theory is based on two key assumptions. The first is that land differs in its fertility—so all lands can be ranked from the most fertile to the least fertile. The second is that competition equals the profit rate among farmers who hire land from landowners. We can then visualise land generating the income flows depicted in box 11.1.

The revenue generated by the economic use of more land has to be shared between landowners, capitalists (the tenant farmers in this model), and workers (the farm employees). The general tendency is for profits to be squeezed because landowners capture a share of the economic surplus generated. Indeed, as more land is brought under cultivation (that is, previously submarginal land becomes marginal), the proportion of the total value of production captured by landowners increases. So, even if wages remain at subsistence levels, the profit share declines.

Therein lies a deeply troubling paradox. According to this analysis, profits are the source of capital accumulation, the driving force in the capitalist system, but they are increasingly hard to sustain as economic expansion occurs. The root problem is that growth is stymied by the diversion of the economic surplus into rent payments. 'Do away with the landowners' is an understandable response. As a member of parliament surrounded by members who typically represented landowners' interests, Ricardo took a more reformist stance. He thought the problem could be significantly reduced by the removal of the impediments to trade that led to less fertile land being brought under cultivation. He argued forcefully that the repeal of the Corn Laws, which protected local agriculture from competition from imports, would counter the tendency for rents to rise at the expense of profits.

Whether more free trade is the appropriate antidote to the power and wealth of landowners remains a contentious point. Restrictions on agricultural trade are still commonly said to be justified by the need to protect the interests of rural landholders and regional communities whose economic prosperity depends on such protection.
Box 11.1

Rent, wages, profit: A Ricardian view

The figure below depicts how the value of the produce from land is shared between landowners, capitalists, and workers. The vertical axis measures the monetary values of the land and its produce, while the horizontal axis measures the amount of land used (the number of hectares, for instance).

The line showing the value of the additional product (for example wheat) from each successive unit of land slopes down to the right as less fertile land is successively brought under cultivation. In other words, the marginal product of land declines as more is used.

The rent is the difference between the value of product generated by each unit of land and the value generated by the marginal unit, that is, the last piece of land brought under cultivation. This is the differential rent. It is the upper limit of what landowners can charge farmers for using their superior quality land (the land that is more fertile than the marginal land). If OA units of land are used, the total rent is the shaded triangular area XYZ.

How is the rest of the value (that is, the area OAYZ) shared among farmers and those who work for the farmers as employees? If, as the preceding chapter argued, employees’ wages are kept at subsistence level (OW in the graph), then the total wage share is shown by the area OAVW, leaving VWZY as the profit share to go to the farmers as a return on their investment of capital and effort.

Now visualise the situation in which the economy has expanded and more land has been brought under cultivation. The share of rent in the total value produced increases. In the extreme, the profit share disappears (when OC land is used). This illustrates the general tendency for profits to be squeezed out between rents and wages. If wages are raised as more land is brought under cultivation, the squeeze is yet tighter. This may occur when food becomes more expensive because inferior land has to be used and the subsistence wage is consequently increased. In that case, the line showing the wage rate would slope upwards to the right, which would mean that profits would be eliminated even more quickly as additional units of land were cultivated. It would bode ill for the future of economic growth under capitalism.
The protection of agricultural interests has been one of the most controversial political economic issues in the development of the European Community, and also in Japan. The Japanese government imposes restrictions on rice imports, seeking to maintain the viability of the local farming sector, whose importance is social and cultural as well as economic. Although the case for such policies is not normally couched in terms of safeguarding landowners’ interests at the expense of capital and labour, that is the usual economic effect. It runs counter to the Ricardian argument for squeezing rents by breaking down the impediments to agricultural trade. The Ricardian view can be considered part of the general case, considered in the preceding chapter, for trade liberalisation based on the principle of comparative advantage. Restrictions like the Corn Laws both boosted rents at the expense of profits and impeded the process of specialisation, which free trade is held to encourage. On this reasoning, it is free trade that is the antidote to the power of landowners to capture the economic surplus as rent. It is a chain of reasoning thoroughly in keeping with the classical political economists’ view of the extension of capitalist markets as a progressive force for economic change.

A GENERAL ASSAULT ON LAND RENT

The argument so far has been couched mainly in terms of agricultural land. However, similar principles apply if we consider the use of land in an urban context. Instead of thinking of the land as having a capacity to ‘earn’ differential rent according to its fertility, we can now visualise its capacity to ‘earn’ differential rent according to its accessibility (to and from a city’s centre of commercial activity). As a city grows, more land is brought into urban use (for housing, industrial purposes, water storage, waste disposal, and so forth). As in the agricultural model, that more extensive land use raises the capacity of existing urban land to earn even higher levels of rent. So, as towns grow, the landowners are the primary beneficiaries—at the expense of capitalists and workers. Some claim that this process is operating in modern cities, with dramatically adverse economic and social consequences. The ideas of Henry George, as well as David Ricardo, are pertinent to understanding these contemporary processes.

As George emphasised, land is essentially a gift of nature. The problems start to arise when it becomes substantially privately owned. As more of nature’s gift is used for income-generating purposes, a greater share of the society’s total income goes to those who have acquired property rights in land. In the historical development of the United States, for example, the westward movement of the settlers, and their capture of the land from the indigenous peoples, vastly increased the material wealth of the settler society. With economic growth in general, the increased value of the land is captured for private rather than public purposes. Coupled with the unequal distribution of its ownership, this exacerbates socioeconomic inequalities. Speculation flourishes as land values change with the spatial pattern of development. That speculation then fuels further socioeconomic inequality, as well as diverting funds from productive purposes. Land may often be held idle because it is bought and sold for speculative gain. The general problems of economic inefficiency and social inequality both have their roots in these tendencies.
Box 11.2

Henry George (1839–97)

Henry George was the founder of a social movement that, in its time, rivalled Marxism as a major force for radical political economic change. His focus on the inefficiencies and inequities associated with the private ownership of land, and on the simple remedy of land taxation, inspired many social activists. The ideas he pioneered are still of significant contemporary relevance.

Unlike most of the other intellectual giants in the history of political economy, George had no academic credentials. As a young man in the United States, he had various jobs, eventually turning to journalism, running a struggling little newspaper in San Francisco. He visited New York in 1869 to set up a telegraphic news bureau for the paper (unsuccessfully, as it turned out, because of opposition from larger and more powerful press and telegraph monopolies). While in New York—then the epitome of the modern capitalist city—he was dismayed by the gross inequalities between rich and poor that he witnessed. He asked himself, why, in a country so blessed by nature, with more than enough resources for all, should there be such maldistribution? By all accounts, the answer—and the remedy—came to him in a blinding flash.

He began writing his analysis of how the appropriation of rents by landowners was at the root of all such economic and social problems, and how a single tax on land rent could resolve these problems. His work appeared in a series of pamphlets and then in his major book Progress and Poverty, which was published in 1879. Progress and Poverty was translated into fifteen languages and sold millions of copies. George travelled internationally preaching his distinctive gospel. In Australia, his public meetings enjoyed massive attendances. George’s diagnosis of the injustices associated with the ‘land question’ had widespread appeal in a ‘frontier’ economy like Australia—comparable to the United States in this respect.

The strong social movement that Henry George started is no longer the force it was. Sadly, it seems more people today are concerned with claiming a stake in the ‘land racket’ than with the reform of public policy regarding land. As a consequence, our cities become more expensive to live in and more socially divided, and most of the economic surplus associated with land price inflation is appropriated for private rather than public use.

It is also important to note that, from a Georgist perspective, the appropriation of the economic surplus in the form of rent is at the expense of ordinary working people. As Henry George said, ‘the increase in land values is always at the expense of labour’. In the Ricardian view, rent is at the expense of profits (since wages are destined to remain at a subsistence level anyway). The Georgist perspective has more widespread political appeal because most people, it seems, would benefit from redressing this source of social injustice.
One obvious solution is public ownership. The collective land resources could then be used according to whatever development plan the society establishes. However, Henry George did not consider this necessary, sharing, in this respect, the classical political economists' aversion to an extensive role for the state in the direct management of economic resources. He favoured a market-oriented approach, but with a uniform land tax. Other classical political economists, notably David Ricardo, favoured substantial land taxes, but George was unique in thinking that a general tax on the site rent of land would be sufficient to finance all the necessary public expenditures of government. A land tax is the best sort of tax, Georgists have consistently argued, because it creates an incentive to use all land for its most productive purpose in order to generate the revenue to pay the tax. By contrast, taxes on labour and capital create disincentives to productive effort. A single tax on land, replacing all personal income taxes, business taxes, inheritance taxes, and taxes on goods and services, is held to be more economically efficient.

Whether a single tax on site rents today could generate sufficient revenue to finance all government expenditures is debatable, given the growth in the array of such expenditures since George's time. But the case for land taxes remains strong. Local property taxation is widely used as a means of taxing land ownership and generating revenue for local governments. As a matter of political pragmatism, some balance between taxation of land, other assets, income, and expenditure seems inescapable. Should land tax play a bigger role in this policy mix? The argument that it should do so is historically grounded in classical political economy. It also addresses contemporary concerns about the diversion of the economic surplus into the hands of people who make no directly productive economic contribution.

CONCLUSION

It is over a century since Henry George noted that the contrast between affluence and poverty was most striking in 'the great cities where the ownership of a little patch of ground is a fortune'. That tendency has been multiplied many times over in the intervening period as cities have grown and land prices escalated. Those land prices are a major element in creating divided cities, and spatial divisions generally. In conjunction with housing markets, land markets commonly lead to a striking spatial segmentation of cities into affluent suburbs and poorer areas, the latter sometimes forming ghettos where socioeconomic disadvantage is perpetuated in a vicious circle. As David Harvey, the leading urban geographer, has argued, the rich command space while the poor are trapped in it.

Real estate, and the intergenerational transmission of its ownership, is a major source of economic and social inequality. This is not a problem of transition between feudalism and capitalism, as it may have been perceived during the age of classical political economy. It is an enduring feature of a society in which income from property ownership commonly outstrips income from productive effort. So, the land question remains at the heart of practical political economy. However, as the ownership of land has become ever more intertwined with the ownership of capital, there is a need for an analysis of unearned incomes in general (from capital as well as land). The study of Marxist economics is inescapable in this context.