

How Capitalism Works

<http://money.howstuffworks.com/capitalism1.htm>



Investing Image Gallery Traders work on the floor of the New York Stock Exchange. Even the United States doesn't have a true capitalist economy. See more investing pictures. **STEPHEN CHERNIN/GETTY IMAGES**

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

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

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

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

Real Capitalism: The Idea



The Industrial Revolution brought about the end of true capitalism. **TIME LIFE PICTURES/MANSELL/TIME LIFE PICTURES/GETTY IMAG**

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

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

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

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

The added philosophical view that turns the social concept of individualism into the economic concept of capitalism came from Adam Smith in the late 1700s. His book, "An Inquiry into the Nature and Causes of the Wealth of Nations," had a profound effect on economic principles. Before Smith, the economic self-interest of the individual was seen as counterproductive -- or at least non-contributory -- to the economic welfare of society as a whole. Smith disagreed with this belief. He suggested two concepts that ultimately became the basis of capitalism:

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

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

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

Buy Buy Buy!

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

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

Real Capitalism: The Practice

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

- There is an owner class: The means of production (capital) are owned only by the few people (capitalists) who can pay for them. Modern means of production are things like machines, factories and land.
- There is a working class: The people (laborers) who use capital to produce goods and have no ownership of that capital. Capitalists pay the laborers with wages (money), not with the products the laborers produce. The laborers

use that money to purchase the goods they want. In this way, no one who purchases goods (the consumer) has any real connection to those goods.

- Rational calculation for profit guides production: The capitalists try to judge the market and adjust production accordingly in order to realize the greatest possible profit.

- Society is made up of consumers: Because people are disconnected from the goods they produce, the process of buying things, not of creating things, becomes the primary way in which people define themselves.

- The more profit the capitalists bring in, the more goods they produce. The more goods the capitalists produce, the lower the price of those goods. The lower the price of goods, the more people can afford to buy, and the higher the standard of living throughout society.

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

Essentially, when more people want something, supply goes down and price goes up. When fewer people want something, supply goes up and price goes down. In the end, it's all about finding a way to turn a profit. Profit results from obtaining or producing goods for less than you sell them for.

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

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

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

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

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

The call for universal healthcare in the United States hints at a further swing toward the socialist economic viewpoint that individual self-interest does not necessarily lead to overall social welfare. With no purely capitalist nor purely planned economies left among the world's major financial players, and with the expansion of far-reaching trade agreements, the future of economics seems to point at a broad market that, economically at least, all but erases national borders and connects the world through financial mobility. <http://money.howstuffworks.com/capitalism5.htm>