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Capitalism

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Capitalism is a system of economic organization, based on private property and freedom of enterprise and contract, in which decisions are coordinated not through coercive mechanisms but through the market. “Economic systems” is the name we give to the different ways in which economic decision making may be organized in a society. Such systems try to answer questions such as what goods and services to produce, how much of each good or service to produce and in what way to produce it, how to distribute the output among all those who have contributed to producing it, how to ensure that the standard of living of the population steadily improves, and so on. And all that has to be done under the real-life conditions of scarcity, ignorance, and uncertainty.

Throughout history, various economic systems have been developed: the tribal economy, feudalism, the planned economy or communism, capitalism, and so on. Intermediate types, displaying features of different systems, have also appeared, such as the war economy and many varieties of mixed economies. Following the crisis of communism, the dominant system has been capitalism.

The Capitalist System

The above definition encapsulates the distinguishing features of capitalism: (1) private property (above all, private ownership of the means of production); (2) the market as the mechanism for coordinating decisions; and (3) freedom of exchange and enterprise for the economic agents vis-à-vis the State and other agents, which implies decentralization of decision making, so that all decisions are made by those most directly affected by them.

The combination of private property and economic freedom gives rise to the incentives that are needed for the agents to base their decisions on criteria of efficiency—efficiency being understood as the achievement of the best possible outcome given the scarce resources available or, alternatively, as the achievement of the desired result using the least possible resources. Under certain conditions, this will lead to a social optimum, by which we mean an efficient allocation of scarce resources to serve goals such as those the agents themselves have freely decided.

The task of coordinating individual decisions is entrusted to the market and the price mechanism. It is assumed that prices contain all, or at least a large part of, the information that the agents need for their decisions to be efficient. Thus, the market performs three broad functions:

Varieties of Capitalism

The outline given above is the core of the theory of the capitalist system. But just as the market is the product of human action, but not of human design (i.e., it is a “spontaneous” order that arises informally and is continually evolving), capitalism, too, has developed in accordance with specific geographical and historical circumstances: through spontaneous evolution, through reactions to the incentives that have been created, and through the deliberate efforts of the agents.

That is why, in the real world, “pure” capitalism does not exist. Instead, we find numerous variants of capitalism, reflecting the various factors that influence the way in which different societies organize their economic activities. In a sense, it would be fair to say that there are as many capitalisms as there are human communities and historical periods: The capitalism of Germany is not the same as that of Taiwan or Brazil, nor is the U.S. capitalism of the 1950s the same as the U.S. capitalism of the 2000s.

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Nowadays, it is common to distinguish between different forms of capitalism. One of them—perhaps the most genuine—is Anglo-American capitalism, represented by the United States, the United Kingdom, Canada, Australia, and New Zealand. Anglo-American capitalism is more individualistic (it assumes that the agents make their decisions based exclusively on their own individual preferences and interests) and more competitive (relations between the agents are more adversarial than oriented toward consensus and negotiation), leaves the agents (persons or organizations) to make their own basic decisions about their future (i.e., it allows only a limited role for the State), puts the emphasis on short-term financial results (as the key to economic efficiency), and concedes an important role to the capital markets.

Another prominent model, which tends to be set in opposition to Anglo-American capitalism, is the continental European model, represented by Germany, Austria, and Switzerland. This model puts the emphasis on the social dimension of decisions (relying on negotiation, agreement, participation, and coresponsibility in decision making), stresses long-term results and social security safety nets that guarantee protection for all citizens (the paradigm for this would be the social market economy, introduced in Germany after World War II), seeks to moderate the free market through a broad array of regulations, and seeks a financial system in which banks play a bigger role than the capital markets. But not all continental European countries fit that model: There are marked differences between, say, France and Germany. There are differences, also, between the Mediterranean countries (Italy, Spain, Portugal, Greece) and the Nordic countries (Sweden, Norway, Denmark, Finland), in which the social security system is far more comprehensive (from cradle to grave), the State plays a much greater role, and incentives also function differently (e.g., when seeking employment).

There is also a Japanese model, which, in its pure form, would include close coordination between economic policy and corporate interests; a system of cross-ownership, forming business groups made up of large companies, their suppliers, and banks; and stable industrial relations, which ensure low labor costs, less conflict, lifetime employment, high productivity, and strong employee loyalty. However, this model is rapidly changing, especially since the 1990s.

It has often been debated which of the various models is the best. There is no one criterion by which to establish an order of preference, so no ranking will be accepted by everyone. In continental Europe, for example, protection of the employment relationship and extension of the welfare state are considered nonnegotiable, so that the apparent advantage of the Anglo-American model in terms of productivity growth is not a conclusive argument.

On the other hand, the ranking of the different models has varied over time. Taking economic growth as a criterion, for example, Europe held the lead in the 1960s, while in the 1980s Japan seemed the model to follow. Since 1995, having achieved only mediocre results in the 1970s, the United States has seen a strong recovery in its growth rate. And now, at the start of the 21st century, China is experiencing tremendous progress. But China is not a pure capitalist economy (nor communist, for that matter); its advantage has a lot to do with the transition from an underdeveloped economy to an industrialized one, although some of its progress is undoubtedly attributable to the introduction of capitalist institutions, markets, and incentives, and the same can be said of some of its problems, such as the growing inequality in the distribution of income and wealth.

Ethical and Social Dimensions of Capitalism

Each generation needs to reach its own conclusions about the social legitimacy and ethical validity of its economic system. Therefore, the fact that the debate on the moral and social aspects of capitalism has been continuing for centuries should come as no surprise. What's more, the same arguments have been put forward time and again. The debate is further complicated when, as often happens, the features of the theoretical or pure model are mixed up with those of capitalism as actually practiced in particular countries and periods.

First of all, it should be pointed out that capitalism is not morally neutral: It is not a purely technical, amoral form of organization but has far-reaching ethical implications. It is possible to describe more or less aseptically how a system works, but moral judgment is somehow inevitable. And from that judgment there derives a set of rules for the system's organization, operation, and results.

To orient our analysis, we must situate the capitalist system within the broader system of society, of which the economic system is a part, whose ideas, **[p. 259 ↓]** values, and attitudes sustain it and whose laws, social norms, ethical precepts, and institutions it shares. In practice, it is impossible to understand capitalism without reference to the society in which it develops. That is why it may be helpful to distinguish between at least four components of any economic system:

In an economic system such as capitalism the web of ideas and values, together with certain aspects of the environment (geography, history, endowment of resources, etc.), specifies the norms and institutions. The norms and institutions, in turn, shape the incentives and coordinate the agents' decisions so that they achieve the goals they have set themselves, individually or in groups. Norms and institutions are products of human action, but they may or may not be the result of human design. Insofar as they are the result of human design, a specific role is assigned to collective decisionmaking mechanisms, especially the ones we know as the State. Now, we are in a position to analyze the problems of social legitimacy and ethical evaluation of capitalism.

The Foundations

As we said earlier, the foundations of capitalism are private property, economic freedom, and coordination through the market. Clearly, our ethical assessment of those foundations will decisively influence our moral and social attitude toward the system as a whole.

1. Capitalism does not flourish in a vacuum but within a legal and institutional framework. A key element of that framework is recognition of the right to private ownership of goods, factors of production, and ideas. Any debate on capitalism starts, therefore, with how to justify that right.

That can be done, for example, by appealing to the principles of justice: People have ownership rights to goods that they have obtained through their own labor or entrepreneurial initiative, or they have ownership rights to goods that they have purchased and possessed peacefully or goods that they need to survive, and so on. Or it can be done by appealing to the principle of freedom: Exercise of private ownership is an indispensable condition for the agent's autonomy. It can also be done by citing natural law, utilitarian arguments, or other reasons that stress the role of efficiency and social welfare: Private property is the best way to conserve and increase material goods and motivate the agents to take personal and social responsibility for their future.

Some authors criticize the individualistic content of the right to private property, as recognized in capitalism, while others accept that right, albeit with limitations (emphasizing the social role of property). In that case, what they are criticizing is not the foundation of the capitalist system as such, but the inadequacy of its legal and institutional system to define property rights appropriately. And there are, of course, those who radically reject the system. Karl Marx, for example, argues that private property constitutes, on the one hand, the right of the capitalist to appropriate the labor of others (the product of their work), and, on the other, the impossibility for labor to appropriate its own product. Therefore, it is a means of abuse of power and, as such, should be abolished. **[p. 260 ↓]** And Pierre-Joseph Proudhon, on the other hand, declares that all property is theft.

2. The various freedoms that form the foundation of capitalism (freedom of exchange, initiative, labor, contract, etc.) are justified by a variety of principles—freedom, efficiency, moral duties, natural law, and so on.

The freedom that takes center stage in the economic agents' decisions is freedom of choice. Attacks on capitalism are not usually targeted at the principle of freedom as such but at this particular interpretation of freedom, as reflected in legislation, institutions, and the theoretical interpretation of the system. Some authors say that this limited conception of freedom is reductionist and incomplete. Others, while accepting the conception of freedom as being centered in choice, criticize the conditions and limitations imposed on the exercise of that freedom in practice—for example, because the unequal power of the economic agents effectively limits the freedom of those who lack resources or because the huge power of companies and the distortions created by advertising effectively prevent consumers from exercising the sovereignty that the system supposedly grants them.

3. As pointed out earlier, in capitalism the agents' decisions are coordinated through the impersonal market mechanism, not by any planning agency. Efficiency is the main argument used to justify the market. For example, the economic theory of welfare shows that under certain (fairly restrictive) conditions the competitive equilibrium in a free market economy is a paretian optimum, as shown by Arrow and Hahn; that is to say, agents acting to satisfy their personal preferences in competitive markets achieve the efficient coordination of all their decisions, guided by the “invisible hand” invoked by Adam Smith.

And yet the idea of coordination by the market is often criticized. Most of the criticism is technical. In practice, the conditions that must be satisfied for that social optimum to be achieved are indeed very strict: perfect competition in all markets (including cost-free perfect information); existence of perfect markets for all goods, present and future; absence of external effects and public goods; the agents' decisions must be based exclusively on their personal preferences and must not include those of other agents, and so on. Given that those conditions are never met, the capitalist system does not, in practice, yield the excellent results it promises, which is not to say that the alternative systems do any better.

In any case, capitalism operates within a legal, regulatory, and institutional framework, whose task is to channel the agents' decisions so as to achieve economic efficiency, coordinate the agents' decisions, and correct any negative effects that arise when reality does not coincide with the assumptions of the theoretical model. For example, in the absence of perfect competition, it is the task of the legal and institutional system to remedy that shortcoming by promoting “sufficient” competition or by correcting the effects of the lack of competition. Any shortcoming of the system is, above all, a shortcoming of the legal and institutional framework.

The Role of the State

The criticisms of capitalism on the grounds of efficiency demonstrate the need for precisely such a legal and institutional framework to foster the necessary incentives so that agents achieve their goals, their decisions are sufficiently coordinated, and economic efficiency is obtained. This means that in the capitalist economic system there is a role for the State. That role consists, basically, of four tasks:

Obviously, we could draw up a much longer list of possible interventions by the State. The three points mentioned above should be seen as the essential minimum to correct the deficiencies of the market system (so-called market failures) as a mechanism for coordinating decisions aimed at efficiency. Some of the other functions attributed to the State are similar to those just mentioned—for example, provision of infrastructure, roads, railroads, schools, and so on, which have at least some of the characteristics of public goods or help correct external effects. Others, meanwhile, are part of what the State needs to perform its functions—for example, creating the necessary administrative services for the State to carry out its tasks of international representation, justice, defense, public order, and so on. There is one more function, however, that is also very important.

4. Providing a minimum income for citizens. The reason for this function is that agents come to the market to obtain certain goods that they do not possess in exchange for goods and services that they do possess and that they have obtained through natural endowment (their labor, for example), inheritance, or donation or through an earlier exercise of their capacity for work or entrepreneurial initiative. Obviously, the agents' capacity for exchange will be limited by their initial endowments, which may be insufficient to guarantee them a minimum standard of living. Therefore, there will be equity (and also efficiency) reasons for ensuring that each agent has a minimum income, although many authors dispute this argument.

Of course, one may also require the legal and institutional framework to contribute to the redistribution of wealth, and there are ethical principles to support that view, though they are not universally accepted. In any case, any effects that such redistribution has on efficiency will also have to be taken into account (if, e.g., the possibility of receiving transfers from the State reduces the incentive to work or act entrepreneurially). This also has a moral dimension, insofar as it affects not only the well-being of society but also the fulfillment of the individuals' responsibilities toward their own future and their contribution to the common good.

The Ethical Limits of Capitalism

Probably the strongest charge against the capitalist system, from the moral point of view, concerns its anthropological assumptions. However, any discussion of these issues lends itself to confusion because it is not always clear what we are talking about: (1) the characteristics that the agent must have for the capitalist system to work, (2) the anthropological characteristics identified by the theoretical model, or (3) the characteristics of real men and women in existing capitalist societies.

1. What the capitalist system demands is that the agents be resourceful, evaluating, maximizing persons. *Resourceful* means capable of improvement, not passive, filled with a desire for what is best. It means that the agents are capable of developing their tastes, preferences, and capabilities, so as to open up new opportunities, thus broadening the variety of agents and their capacity for specialization. *Evaluating* means that the agents do not look at the world through indifferent eyes but analyze, order, and compare states of the world to choose between them. And *maximizing* means that the agents always try to obtain the best they can from the scarce resources at their disposal. Provided the agents have these characteristics, even if only to a partial and limited extent, the system will work. And it seems reasonable to assume that real-life men and women do indeed have those characteristics, or at least a lot of them do.

2. The theoretical model of capitalism is quite a different matter. It tends to specify those characteristics much more closely, depending on the need for detail and precision of conclusions. It is assumed, for example, that the agents are driven exclusively by self-interest and often that they are selfish. It is assumed, also, that the agents are rational, in the sense that they have a preference function with certain conditions (continuity, **[p. 262 ↓]** internal consistency, divisibility of goods, etc.). Often, it is further assumed that their calculation ability is perfect and that they have all the necessary information (all these being assumptions that are criticized by those who believe that rationality is bounded).

Obviously, though, those specifications are not required for the capitalist system to work. For example, the agents must be capable of identifying the goals of their actions, which as a rule will be their own personal goals but which may also be oriented toward the interests of other agents (altruism, solidarity). Selfinterest means simply that each person is capable of identifying the goals of his or her actions. And needless to say, people's goals do not have to be “selfish,” in the sense of ignoring the effects that their actions have on others or not including other people's interests in their preference function. It does not seem legitimate, therefore, to criticize capitalism for the assumptions on which the theoretical models are based or for the implications of those models—although it is not always easy to identify which assumptions are part of the theoretical apparatus and which are relevant to the capitalist system in practice.

It should also be pointed out that the economic optimum, which economics tells us is achieved in a system of private property and free enterprise, is not devoid of ethical content. In effect, what is achieved is a Pareto optimum, that is, a situation in which no change can be made without benefiting one party to the detriment of another. An optimum, thus defined, is not ethically neutral, however. It is based on utilitarian assumptions that have been widely debated. It is only natural, therefore, that the situation achieved under a capitalist system should be considered ethically unacceptable under other moral assumptions.

3. Last, we must consider the set of ideas and values of the flesh-and-blood agents who actually make decisions in the capitalist system. We already pointed out that these ideas and values are plural, disordered, sometimes contradictory, and always changing. What is often criticized about the capitalist system is precisely that set of ideas and values.

That criticism may be important, but it is unfair. It may be important insofar as capitalism, because of the way it works, promotes values that, at least from certain ethical viewpoints, may be described as immoral, because they are individualistic, selfish, uncaring, and so on. In a word, the theoretical model does not take into consideration the mechanisms of moral learning (acquisition of virtues or vices) at work in people's lives. But it may also be unfair insofar as those values are provided by society (the “values market” mentioned earlier), which offers or imposes them on the agents and on the economic system.

The problem becomes even more complicated if we consider that individual and social ideas and values are channeled through laws and institutions. From the moral point of view, it would seem natural to expect society to set up the legal and institutional framework so that it encourages ethically correct and economically efficient behavior and discourages undesirable behavior. But that is not the function of the economic system. The invisible hand referred to by economists is an economic, not an ethical, mechanism. It works to harmonize the decisions of millions of agents acting in accordance with their—selfish or altruistic—personal interests. But the result is an economic, not an ethical, harmony. In capitalism, as in other economic systems, there is no “ethical invisible hand” that works automatically to bring about the improvement of people and the achievement of higher social goals.

Ultimately, the final moral evaluation of the economic system is a moral evaluation of the society of which the economic system is a part. The economic system is not self-sufficient: It needs the abovementioned legal and institutional, and through them, moral mechanisms that lead society toward an ethically better situation.

All this becomes clearer if we consider the purpose of the economic system, which we have identified as efficiency. In economics, efficiency is defined as a comparison of the resources actually used with the goal pursued: It is always efficiency “for something,” for a particular purpose. How that goal or purpose is defined will, in a way, give us the key to the morality of the system whose efficiency we are trying to evaluate. Capitalism efficiently produces weapons, food, drugs, and textbooks, and the moral value of its production will have to be assessed from outside the system.

The thoughts set out in the preceding paragraphs help us to better understand some of the criticisms commonly leveled against capitalism, for example, the criticism that puts the emphasis on how limited the market is—many activities are completely omitted, such as friendship, family, religion, artistic creation, culture, and so on. That is obviously not a shortcoming of the capitalist system, however, but an acknowledgment that a mechanism whose purpose is to achieve efficiency in the use of scarce resources cannot possibly **[p. 263 ↓]** account for every facet of human activity. And the fact that, in recent years, people have developed economic theories of the family, art, religion, altruism, culture, and so on does not alter that argument, because in every human decision involving the use of scarce resources to achieve alternative goals there is room for economic reasoning. That is not to say, however, that such a decision is exclusively economic.

To end this section, it will do no harm to recall that the capitalist system also develops—and demands—moral values such as honesty, integrity, trust, keeping one's word, respect for the law, and many others, and it fosters an entrepreneurial spirit, generosity, risk taking, vision of the future, personal responsibility for building one's own life, and so on. And it also demands values. For example, many economists say that the social responsibility of a company manager is to conduct the business in accordance with the owners' desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Ethical ideas and values, embodied in legislation, regulations, institutions, and social culture, are necessary for capitalism to work efficiently.

The Results

The last block of criticisms and defenses of capitalism concerns the actual results. The following are some of the arguments:

The debate on economic systems tends to be impassioned, because it brings into play crucial aspects of the underlying conception of the human person and society. Opinions are very unlikely to converge when the starting paradigms are so different. Nevertheless, study, reflection, and dialogue may help find points of agreement and identify the reasons for disagreement. This entry has offered an outline that may help identify, first, what is essential in the capitalist system and, second, what aspects of the capitalist system are most criticized.

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See also

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