capitalism

Britannica Student Encyclopedia

An economic system that features private ownership of the means of production (such as factories, offices, and shipping enterprises) and in which market forces determine the way in which goods are produced and the means by which income and profit are distributed is called capitalism.

Other names for this system are free market economy and free enterprise. All three terms were coined in the late 19th and the early 20th century to describe economic arrangements that began developing centuries ago in Europe. Alternatives to capitalism include central planning (or “command” economies, such as communism) and those based on the principle of tradition, as experienced in monarchies. Because a pure form of each economic system exists only in theory, most economic systems follow a particular approach but incorporate aspects of other systems. Mixed economies that emphasize central planning and government ownership of all forms of production are examples of socialism.

The word capital refers to resources—such as human labor, machinery, land, buildings, and money—that are used to produce other goods and services. These resources are also called factors of production, because they contribute to the production of goods from farms, factories, small enterprises, and offices. The capitalist is the individual—or group of individuals—who invests money in an enterprise in exchange for potential profits in the future.

In the context of capitalism, the term private property has a specific definition: it signifies the means of production. A farm as property offers the means by which food is produced, just as a factory as property represents the means by which durable goods are produced. As an example of services a physician's office and equipment are the physician's property, which the physician uses in the treatment of patients. The heart of capitalism rests on the entrepreneur's right to produce what he or she wishes and the consumer's right to choose what to buy, so long as goods or services being exchanged are lawful.

The other two terms used to describe capitalism, free market economy and free enterprise, put a slightly different slant on the meaning. They have in common the word free, but economic liberties should not be confused with political liberties such as those experienced in a democracy; in other words, it is possible for a capitalist economic system to develop within a socialist economic system. The implication is that people are free to choose how they use their capital resources (for example, they decide how much to save, how much to spend, and on which goods and services their savings are spent). Successful free enterprise systems also rest on the above-stated right to own property, meaning that individuals have the right to do what they wish with their property, as long as it does not harm anyone else. (The rights of property owners will vary, however, between countries or various jurisdictions.) These freedoms set capitalism apart from all other kinds of economic arrangements: all other economic systems operate as top-down, command-and-control political systems in which personal freedom and the rights of property are considered secondary to the needs of the state.

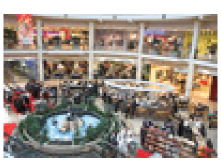
The creation of wealth in the past few centuries was made possible because capitalism emerged in free, or nearly free, societies that allowed individuals to seek to better their own conditions without being given orders by higher authorities. In other words, the economic system of capitalism offers the means by which individuals are motivated to improve their lives through hard work and innovation.

It was the first modern economist, Adam Smith, who noted in 1776 that individuals naturally seek their own advantage. This can be achieved in two ways: by individual effort or at someone else's expense. But it is impossible for everyone to succeed at everyone else's expense. Therefore most individuals will contribute to a productive economic system, seeking to do or make something that others will pay for, or they will work for an organization that makes products or provides services that are purchased and used by others.

In pursuit of their own advantage, people in a capitalist economic society use their imaginations. They innovate by finding new ways to do old tasks. They discover new solutions to old problems and develop new products. Such innovation is the foundation of continued wealth creation. For example, communication by wire started with the invention of the telegraph. Then came the telephone and voice communication by wire. This was followed by radio, wireless communication. Next was sending visual signals to television sets. Now global communication can be transmitted through networks of fiber-optic cable, microwave transmission towers, and satellites orbiting the Earth. One innovation built upon another. Free people in a free market economy provided the funding for these innovations and inventions, and market forces determined the demand for these new means of communication. Such dynamism fills the marketplace with innovative and useful products, and it contributes to higher standards of living for a greater number of people.

An aspect of this dynamism is seen in the Industrial Revolution. This long-term development truly revolutionized the way goods were produced, and it created employment for millions of individuals. Although the earliest working conditions in the Industrial Revolution were often difficult, dangerous, or unhealthy, public awareness and social movements led to better employment standards. The result has been safer job conditions, fairer labor practices, and a significantly improved standard of living for whole societies. (*See also* Industrial Revolution; industry; mass production.)

Characteristics of Free Enterprise



A shopping mall offers a great array of goods, or circulating capital, to customers.
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In addition to personal freedom, private property rights, and innovation, capitalism is characterized by the specialization of jobs (known as the division of labor), a price system, profits, and generally accepted rules. None of these originated with capitalism. They have existed as long as people have performed economic functions. The difference lies in the distinctive roles they were made to play in the free market economy.

Capitalism is society organized as a market, in contrast to society organized as government and subjects. Money, land, machinery, labor, channels of distribution, and buying and selling all work together to form such a market. Some institutions, notably government and religion, stand apart from the market; but they also depend upon the wealth it creates for their well-being. Taxes, for instance, are portions of wealth taken from society to pay for government functions.

Division of Labor

At one time nearly all work was agricultural. (In poor countries it still is.) As civilizations developed and cities were formed, the role of agriculture as an employer of people began to diminish. Individuals undertook new tasks: mining, handicrafts, trade, and weaving cloth, for example. This simple division of labor paved the way for a greater creation of wealth in a society, because it permitted people to specialize in certain types of work, thereby creating more efficient ways for producing the wares required in daily life. Greater quantities of goods, in more varieties and of better quality, were produced for commerce and trade.

In contrast to the earliest agricultural societies, the division of labor in the contemporary world is extraordinary, represented to consumers by the great diversity of products and services available. The division of labor is more clearly evident in the factories that make these products. A look into an automobile plant, in which cars are assembled in a series of steps, will show specialization along a production line: managers have decided which tasks each worker will perform, and they have also determined which production tasks can be handled by machines, and which must be performed by humans.

Price

In a market economy, price is the controlling factor. If a seller charges too much for a product or service, buyers in a free market economy will turn to other vendors who offer fairer prices. Likewise, a seller who charges too little might fail to keep up with demand for products—or worse, the seller might not earn enough to cover the costs of the products for sale. The price mechanism brings order to these economic exchanges. Certainly prices have existed as long as goods and services were bought and sold. But only under capitalism did land, labor, money, and resources all become subject to the price mechanism. In capitalist economic systems, nearly everything is subject to price, because price is the fairest means of allocating the factors of production to their best use. Price is essentially a rationing system for all factors of production.

Prior to capitalism land, labor, resources, and money were largely under government control or under the control of wealthy elites with close ties to government. During the European Middle Ages, for instance, land was required to remain the property of a family for generations. Similarly, ordinary people were locked into specific jobs that were carried on by their descendants generation after generation: being a farmer or artisan was passed from father to son and from mother to daughter. Production was undertaken to support the state and religion, and the very little left over had to suffice to sustain the mass of people (*see* feudalism).

Although the continuous development of capitalism as a system dates only from the 16th century, antecedents of capitalist institutions existed in the ancient world, and flourishing pockets of capitalism were present during the later European Middle Ages. The development of capitalism was spearheaded by the growth of the English cloth industry during the 16th, 17th, and 18th centuries. What distinguished this era of capitalism from previous systems was the use of profits to expand production in ways that could create even greater wealth. Before this, profits were just as likely to be spent on luxuries or invested in economically unproductive projects, such as the construction of monuments, palaces, pyramids, and cathedrals.

Over time, the medieval system in Europe gave way to a new social and economic order: land was sold by kings and nobles in desperate need of money. Workers and craftspeople, driven from the land that had been owned by their lords and masters, became a landless class of poor subsistence workers. But as a market economy started growing, these poor were able to hire themselves out as laborers for whatever wages they could command. A wage is considered a price—in this case, a price paid for labor.

Just as products command a price, so money, too, can be obtained for a price—the price of borrowing it. This price is called interest. The rate of interest varies with the supply of money available for investment in an enterprise. Like money, the other factors of production are not in unlimited supply. When it is free to react to market conditions (such as supply and demand), the price mechanism proves to be the most useful way of allocating all the factors in the economy in the most efficient way. A large labor supply in one place naturally tended to depress wages, so workers went to other places where they could obtain a greater price for their labor. A shortage of a resource such as copper tended to raise its price, while the discovery of new copper mines lowered it by increasing the supply. When replacement materials for commodities such as copper are either discovered or invented, these so-called substitute commodities also reduce prices. Thus, the development of fiber-optic cable reduced dependence on copper wire, just as kerosene and electricity had eliminated the reliance on whale oil for lamps and lighting.

In a perfectly free market (which exists only in theory), prices tend to be stable. Resources are allocated to those who can make best use of them at the time. The level of employment also tends to be stable and high, because workers will go where they are most needed. If the carriage maker's factory closes because automobiles are making carriages obsolete, the labor force will shift to the new industry.

When carriages can no longer be sold, their prices collapse; but the prices of cars will increase. In this way prices work together with supply and demand to sort out the elements of the economy. Pricing is therefore somewhat like an ongoing auction, with the buyers bidding for the specific factors they need, whether it be money, workers, raw materials, or land. This is also known as an allocation of resources. If there were enough of everything for everyone, prices would be unnecessary; but then, there would be no need for an economic system either.

Profit

This has been the most controversial aspect of capitalism, because it has been so thoroughly misunderstood. Critics of capitalism have contended that profit was the goal of capitalist greed: something to which the workers were rightfully entitled but which the bosses stole; or something extra for the owners above all real costs. One reason profits have gained a bad reputation is the popular misconception that company profit margins are enormous. In fact they are quite small in proportion to total revenues—usually running about 5 to 6 percent of total sales, but often less—in fact, some companies with very high sales volumes, such as discount retailers and grocers, might have profit margins in the range of 1 to 2 percent.

Profit is, in fact, nothing more than the portion of revenue that exceeds current expenses. A business that earns a profit is not only able to keep operating; it is also able to innovate, to seek new markets, and to expand with new machinery and plants. Without profit, only the costs of current production, such as raw materials and wages, would be covered. If there were a loss, even those costs could not be paid. In any business, profit acts as a signal to indicate the health of the company. A loss signals serious problems. A company that covers only costs but earns no profit will have few options for change. Winning over new customers will be unlikely because advertising and sales promotions cannot be afforded, nor can new products be developed or efficient plants constructed.

Rules

Order is brought to the economy by the price system and by rules that everyone agrees upon. Some rules are common to society: for example, no theft or fraud shall be permitted, nor will any transactions involve illegal goods or services. In an increasingly complex economic system, other requirements, such as licensing, certification, or proof of citizenship, will limit access to the market. Many transactions are also guided by the rules of contract. Contracts are voluntary (but legally binding) agreements entered into by two or more individuals. They normally specify the performance of some work or delivery of specific goods at a certain time. A contract therefore is a set of promises signed by the parties to it. As such, a contract has the force of law; and there is a whole branch of law devoted to contracts. The establishment and recognition of property rights also play a major role in ordering an economy. Of increasing importance is the recognition of intellectual property—intangible items that represent great value to their owners. Copyrights and trademarks represent a form of property, for example, because they are signs of ownership. Property rights can also be infringed by counterfeiting and forgery, and by copyright and trademark infringement. (*See also* contract.)

Unplanned order

The four characteristics described above (division of labor, price, profit, and rules) have worked together to establish a society (even on a global scale) connected by an intricate network of market relationships. This market system was unplanned. It evolved slowly, as did the rules by which it operates. The market is a product of spontaneous human action but not human design. People, impelled by nature to maximize their well-being, created what proved to be workable arrangements that augmented individual and social prosperity. The market system does not depend on people sharing the same values, belonging to the same ethnic group, or having the same religion. It does not even depend on their liking each other. It is rooted only in the common desire to improve the material conditions of one's life.

Goods and services

Given the great variety of items sold in a capitalist economic system, a distinction must be made between goods and services. In the case of goods, something is produced: food, clothing, cars, houses, and more. Goods are also called products or commodities (though sometimes commodities are natural resources). Services are not products, though services use many products. A motion picture, for example, is a product, but some means of delivering that product are defined as a service. To show the movie publicly is to provide a service that involves film, a projector, and a theater. Customers see the movie but they do not take anything home with them except the memory of the entertainment. By comparison, a DVD copy of the same movie purchased for home use is considered a product.

There is another significant difference between goods and services. Products provide the basic wealth of society, because wealth is typically represented by tangible goods. A service cannot be wealth, because once it has been performed it ceases to be. Services can, however, be a signal of wealth, because societies that have produced a great deal of wealth, such as the United States, Germany, and Japan, are notable for the variety and quantity of services. By contrast societies that have little wealth will have fewer services available. People in such poor countries can barely afford the necessities, much less the luxury of services—even such important ones as medical care. A society depends on the continued creation of wealth for its prosperity and survival. Services cannot perform this function. They depend, in fact, upon wealth creation for their continued improvement.

Consumers and Value

Just as producers sell goods and services, customers buy value for themselves. In a truly free economy the consumer is thus the dominant partner in the relationship, because it is the consumer who ascribes value to his purchases—or he would not make them. Products and services that consumers do not want have no market value, no matter how highly the producers regard them.

In the past some economists mistakenly assumed that producers created value by the effort, material, and time that went into making a commodity. But the time and effort put into a product or service cannot be readily quantified. To be sure, there are costs of production, but they are influenced by the price the producer believes he will get from selling the product. The producer, in other words, must try to guess what value the consumer will ascribe to the product and estimate the price customers would be willing to pay for the product; then he must adjust all production costs accordingly.

The role of the consumer in determining value indicates that the market system parallels some of the ways in which a democracy operates. Consumers “vote” for or against products and services with the money they spend. If a product fails to meet the buyers' expectations, the buyers will switch to another; and the producer will be voted out of business. Workers can also vote by moving away from jobs with poor pay or unhealthy conditions to jobs that pay higher wages and offer a safe working environment.

Critics of Capitalism

Supporters of capitalism declare that economic freedom is the most basic of human liberties, because it creates greater opportunities for advancement for the greatest number of people. Yet the market system has been strongly criticized by opponents who claim that it fails to provide an equally high standard of living for all. The claim is true: there are and always will be inequalities of wealth under capitalism, but they are not as extreme as the inequalities to be found in other economic systems.

The goal of equality of wealth can only be pursued by force, and governments must do the forcing. An economy itself has no mechanisms of coercion available to it. Those 20th-century systems that relied on force—communism and fascism—failed to achieve a high standard of living for any but a minority. But these are not economic systems; they are political systems. The market economy, by contrast, does not guarantee equal outcomes for all. It merely operates on the assumption of liberty and equality under law for all participants. Success in a free market depends in large part on individual effort and ability, but effort and ability are unevenly distributed among human beings. (*See also* communism; fascism.)

Capitalism has been denounced for having business cycles, periods of "boom and bust." (*See also* business cycle; inflation.) Although individuals and societies tend to prefer security and stability, it is true that capitalism is always changing. But an economy is never a finished process. The market economy is dynamic, flexible, and always in flux, because its continuation depends to a great extent on technological change, new information, and innovation. New needs emerge and alternate means of producing established products are devised. Just as industrializing economies saw losses in the number of farming jobs, so now the number of manufacturing jobs is shrinking worldwide. Such dislocations are inevitable, as the economy continually corrects and readjusts itself. Attempts to halt or reverse change would, if successful, lead to stagnation and a decline in the standard of living.

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