In a word, capitalism was more than just a change in social institutions; it was also a completely new economic order.

Capitalism and the Profit Motive

Much of this book is concerned with examining how this new order works—what problems inhere in its complicated process of commodity production and sale. This takes us to an examination of the changing institutional forms that capitalism has created, as well as into an inquiry into some of the economic mechanisms by which the system works.

But it is useful to focus immediately on one aspect of capitalism that would occupy a central and indispensable place in its scheme of things. This was a new form of behavior that capitalism generalized throughout society: a drive to maximize income (as the economists would describe it) by concluding the best possible bargain on the marketplace into which everyone ventured, either to sell his or her labor power or other resources, or to purchase goods. In the language of business, the same behavioral drive was described as the *profit motive.*

The market society had not, of course, invented this motive. Perhaps it did not even intensify it. But it did make it a ubiquitous and necessitous aspect of social behavior. Although men may have felt acquisitive during the Middle Ages or antiquity, they did not enter en masse into market transactions for the basic economic activities of their livelihoods. When, for instance, a peasant sold his few eggs at the town market, rarely was the transaction a matter of overriding importance for his continued existence. Market transactions in a fundamentally nonmarket society were a subsidiary activity, a means of supplementing a livelihood that, however sparse, was largely independent of buying or selling.

With the monetization of labor, land, and capital, however, transactions became universal and critical activities. Now everything was for sale, and terms of transactions were anything but subsidiary to existence itself. To a man who sold his labor on a market, in a society that assumed no responsibility for his upkeep, the price at which he concluded his bargain was all-important. So it was with the landlord and the budding capitalist. For each of these a good bargain could spell riches—and a bad one, ruin. The pattern of economic maximization was generalized throughout society and given an inherent urgency that made it a powerful force for shaping human behavior. The drive to maximize income became a new mode of social coordination and control.

THE INVENTION OF ECONOMICS

The new market society did more than merely bring about an environment in which men were not only free, but *forced,* to follow their self-interest. It also brought a puzzle of great importance and considerable difficulty. The puzzle was to understand the workings of a world in which profit-seeking persons were no longer constrained to follow the ways of their forefathers or to shape their economic activities according to the dictates of a ruling lord or king.

The "Philosophy" of Trade

The new order needed a "philosophy"—a reasoned explanation of how such a society would hang together, would "work." Such a philosophy was by no means self-evident. In many ways, the new world of profit-seeking persons appeared as perplexing and

fraught with dangers to its contemporaries as it did to the imaginary leaders of a traditional society to whom we described it in our first chapter.

It is not surprising that the philosophers of trade disagreed. In England, a group of pamphleteers and merchants, the so-called Mercantilists, put forward an explanation of economic society that stressed the importance of gold and extolled the role of the merchant, whose activities were most likely to bring "treasure" into the state by selling goods to foreigners. In France, a school of thinkers we call the *Physiocrats* held quite different ideas. They exalted the virtues of the farmer, not the merchant. All wealth ultimately came from nature's bounty, the Physiocrats argued, dismissing merchants and even manufacturers as belonging to a "sterile" class that added nothing to the wealth produced by the farmer. Labor was assumed to be poor, although not necessarily "wretched."

With such diverse views, it is obvious that nothing like unanimity prevailed concerning proper economic policy. Should competition be regulated or left alone? Should the export of gold be prohibited, or should "treasure" be permitted to enter or leave the kingdom as the currents of trade dictated? Should agricultural producers be taxed because they were the ultimate source of all wealth, or should taxes fall on the prosperous merchant class? The answers to these perplexing questions awaited the advent of Adam Smith (1723–1790), patron saint of our discipline and a figure of towering intellectual stature. His masterwork, *The Wealth of Nations*, published in 1776, the year of the American Revolution, gave to the Western world the first full account of something it dearly wanted to know—how its own economic mechanism worked.

Division of Labor

The world that Smith described was very different from our own. It was a world of very small enterprises: Smith's famous description of a pin factor involves a manufacturing establishment that employs 10 people. It was still hampered by medieval guild restrictions: In Smith's time, no master hatter in England could employ more than two apprentices; in the famous Sheffield silver trade, no master cutler could employ more than one. Still more important, it was a world in which government-protected monopolies were accorded to certain fields of commerce, such as the trade with the East Indies. However, for all the differences from modern economic society, the basic vision that Smith gave to his time can still elucidate the tasks of economics in our own time.

Two main problems occupied Smith's attention. The first is implicit in the title of the book. This is Smith's theory of the most important tendency of a society of "perfect liberty"—its tendency to grow.[15]

Economic growth—that is, the steady increase in the output of goods and services enjoyed by a society—was hardly a concern for philosophers of tradition-bound societies, or even of societies ruled by imperial-minded emperors. But what Smith discerned amid the seeming turmoil of a market society was a hidden mechanism that would

[15]By "perfect liberty," Smith emphasized that all agents in such a society were free to enter, or not to enter, into economic arrangements such as the wage contract, in sharp contrast to the *obligations* imposed on serfs and slaves. That "liberty" may not have appeared very precious to the "freely contracting" owner of labor in a London slum. Nonetheless, there was a difference—a legal difference, not yet invented in his time—that Smith correctly identified as crucial for the system of capitalism. Incidentally, *capitalism* was a word even Karl Marx used only once or twice.

operate to enlarge the "wealth of nations"—at any rate, those nations that enjoyed a system of perfect liberty and did not tamper with it.

What was it that drove society to increase its riches? Basically, it was the tendency of such a society to encourage a steady rise in the *productivity* of its labor, so that, over time, the same number of working people could turn out a steadily larger output.

And what lay behind the rise in productivity? The answer, according to Smith, was the gain in productiveness that was to be had by achieving an ever-finer *division of labor.* Here Smith's famous pin factory serves as an example:

> One man draws out the wire, another straits it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on is a peculiar business; to whiten it is another; it is even a trade by itself to put them into paper. . . . I have seen a small manufactory of this kind where ten men only were employed and where some of them consequently performed two or three distinct operations. But though they were poor, and therefore but indifferently accommodated with the necessary machinery, they could, when they exerted themselves, make among them about twelve pounds of pins in a day. There are in a pound upwards of four thousand pins of middling size. Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day. . . . But if they had all wrought separately and independently . . .they could certainly not each of them make twenty, perhaps not one pin in a day.

Adam Smith's Growth Model

This begins to unravel the reasons why a society of free enterprise tends to grow. But it does not fully explain the phenomenon. For what is it that drives such a society to a division of labor? How do we know that the tendency to growth will not peter out, for one reason or another?

This leads us to the larger picture that Smith had in mind. We would call it a "growth model," although Smith used no such modern term himself. What we mean by this is that Smith shows us both a propulsive force that will put society on an upward growth path and a self-correcting mechanism that will keep it there.

First the driving force. One of the fundamental building blocks of Smith's conception of human nature was what he called the "desire for betterment"—what we have already described as the profit motive. What does the desire for betterment have to do with growth? The answer is very important: *It impels every manufacturer to expand his or her business in order to increase his or her profits.*

How does this business expansion result in a higher division of labor? The answer is very neat. The main road to profit consists in equipping workers with the necessary machinery that Smith mentions in his description of the pin factory, for it is this machinery that will increase their productivity. Therefore, the path to growth lies in what Smith called *accumulation,* or in more modern terminology, the process of *capital investment.* As capitalists seek money, they invest in machines and equipment. As a result of the machines and equipment, their workers can produce more. Because they produce more, society's output grows.

The Dynamics of the System

This answers the first part of our query. However, there is still the question of how we know that society will continue to grow, that its trajectory will not flatten out. Here we come to the cleverest part of Smith's model. At first look, it might seem as if the drive to increase capital investments would be self-defeating. The steady increase in the demand for workers to run the new machines would drive up their wages; as wages rose, they would cut into the manufacturer's profits. In turn, as profits were eaten away, the very source of new investment would evaporate, and the growth curve would soon level off.

Not so, according to Smith. To be sure, the rising demand for workers *would* tend to drive up wages, but this was only half the picture. The same upward tendency of wages would also tend to increase the supply of workers. The reason is not implausible. In Smith's day, infant mortality was shockingly high: "It is not uncommon," Smith remarked, ". . . in the Highlands of Scotland for a mother who has borne twenty children not to have two alive." But as wages rose, infant and child mortality would tend to diminish, and therefore more of the population would survive to working age (10 or younger in Smith's day).

The outcome must already be clear. Along with an increase in the demand for workers (and working children) comes an increase in their supply. This increase in the number of available workers meant that the competition for jobs would increase. Therefore, the price of labor would *not* rise, at least not enough to choke further growth. Like a vast self-regulating machine, the mechanism of capital accumulation would provide the very thing it needed to continue unhampered: a force to prevent wages from eating up profits. The growth process could go on undisturbed.

We will not concern ourselves here with the full details of Smith's growth model. Of course, his "model" is not directly applicable to the modern world, where (at least in industrialized nations) most children do not die before they reach working age and where his "safety valve" therefore has no relevance. Nonetheless, in Smith's depiction we get a sense of the imaginative reach and capacity for enlightenment that economic analysis can bring.[16]

The Market Mechanism

The wealth (we would say the output) of nations was not, however, the only major problem on which Smith's treatise threw a clarifying light. There was also the question of how a market system held together, of how it provided an orderly solution to the problems of production and distribution.

This brings us to Smith's description and explanation of the market mechanism. Here Smith begins by elucidating a perplexing problem. The actors in Smith's drama, as we know, are driven by the desire for self-betterment and guided mainly by their

[16]It seems necessary to add a word to the student who gets sufficiently interested in Smith's model to look into the *Wealth* itself. The student will look in vain in this vast, discursive book for a clear-cut exposition of the interactions we have just described. The model is implicit in Smith's exposition, but it lies around the text like a disassembled machine, requiring us to put it together in our minds. Nonetheless, it is there, if one fits together the pieces. For a fuller exposition, see R. Heilbroner, *The Essential Adam Smith* (New York: W. W. Norton, 1986).

self-interest. "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner," writes Smith, "but from their regard to their self-interest. We address ourselves not to their humanity, but to their self-love, and never talk to them of our necessities, but of their advantages."[17]

The problem here is obvious. How does a market society prevent self-interested, profit-hungry men from holding up their fellow citizens for ransom? How does a socially workable arrangement emerge from such a socially dangerous set of motivations?

The answer introduces us to a central mechanism of a market society, the mechanism of competition. For each person, out to do the best for himself with no thought of others, is faced with a host of similarly motivated persons who are in exactly the same position. Each is only too eager to take advantage of his or her competitor's greed if it urges the competitor to raise his or her price above the level "set" by the market. If a pin manufacturer tried to charge more than its competitors, they would take away its trade; if a worker asked for more than the going wage, he or she would not be able to find work; if a landlord sought to exact a rent steeper than another with land of the same quality, he or she would get no tenants.

The Market and Allocation

But the market mechanism does more than impose a competitive safeguard on the price of products. It also arranges for the production of the right *quantities* of the goods that society desires. Suppose that consumers want more pins than are being turned out and fewer shoes. The public will buy out the existing supply of pins, while business in the shoe stores will be dull. Pin prices will tend to rise as the public scrambles for shrinking supplies, and prices of shoes will tend to fall as merchants try to get rid of their burdensome stocks.

Once again, a restorative force comes into play. As pin prices rise, so will the profits of the pin business, and as shoe prices sag, so will profits in shoemaking. Again, self-interest and the desire for betterment go to work. Pin manufacturers will expand their output to take advantage of higher prices; shoe factories will curtain production to cut their losses. Employers in the pin business will seek to hire more factors of production—more workers, more space, more capital equipment; employers in the shoe business will reduce their use of the factors of production—letting workers go, giving up leases on land, cutting down on their capital investment.

Therefore, pin output will rise and shoe output will fall, *but this is exactly what the public wanted in the first place!* Through what Smith called, in a famous phrase, an "invisible hand," the selfish motives of people are transmuted by the market mechanism to yield the most unexpected of results: social well-being.

The Self-Regulating System

Smith showed that a market system, far from being chaotic and disorderly, is in fact the means by which a solution of the strictest discipline and order is provided for the economic problem.

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[17]Adam Smith, *The Wealth of Nations* (New York: Modern Library, 1937), p. 14.

First, he explained how the motive of self-interest provides the necessary impetus to set the mechanism to work. Next, he showed how competition prevents any individual person from exacting a price higher than that set by the marketplace. Third, he made clear how the changing desires of society lead producers to increase production of wanted goods and to diminish the production of goods that are no longer as highly desired.

Not least, he showed that the market system is a self-regulating process. The beautiful consequence of a competitive market is that it is its own guardian. If prices or profits or wages stray away from their "natural" levels determined by cost, forces exist to drive them back into line. Therefore, a curious paradox emerges: The competitive market, which is the acme of individual economic freedom, is at the same time the strictest of economic taskmasters. One may appeal the ruling of a planning board or win the dispensation of a minister, but there is no appeal, no dispensation, from the anonymous pressures of the competitive marketplace. Economic freedom is more illusory than it appears. You may do as you please, but if you please to do that which the market disapproves, the price of freedom is ruin.

The Market System and the Rise of Capitalism

Does the market system really work as Smith's great treatise suggests? Much of the rest of this book is devoted to that question—that is, to tracing the growth and the internal order of the system whose prospects Smith's model described so brilliantly. The fact that we have suffered business cycles and depressions, and that giant business firms and labor unions have taken the place of pin factories and child workers, is evidence enough that Smith's model alone will certainly not serve as a dependable guide through economic history. The fact that our economy has grown prodigiously and that it has hung together, despite all its problems, is also evidence that there is an important kernel of truth in Smith's conception.

Let us return to our historical narrative, to see how much of what Smith foresaw came true and how much did not, and for what reasons. *The Wealth of Nations* appeared before capitalism assumed anything like its current industrial guise. After all, serfdom was not formally abolished in Germany until a half century later. Even in Adam Smith's England, the market society had not yet reached the stage in which capitalism achieved full legal and political status. For example, the guild regulations that irked Smith did not vanish until the medieval Statute of Artificers was repealed in 1813. Likewise in France, until the revolution of 1789, an immense web of regulations bound the would-be capitalist. Rules and edicts, many of them seeking to standardize production, laid down the exact number of threads to be woven into the cloths of the French textile manufacturers, and to disregard these laws was to risk pillorying—first for the cloth, then for the manufacturer.

Well into the eighteenth century, we find the great revolution of the market still incomplete; or rather, we find the nearly complete process of monetization and commercialization contained uncomfortably within a frame of legal and social organization not yet fully adapted to it. We will have to observe how capitalism burst through the restrictions of the precapitalist, mercantilist era before we can see Adam Smith's marvelous market mechanism in full operation.

Key Concepts and Key Words

Feudalism

1. *Powerful forces of change* were operative within European feudalism and served gradually to introduce the structure of a market society. Primary among these forces were:
   - The role of the *itinerant merchant* in introducing trade, money, and the acquisitive spirit into feudal life.
   - The *process of urbanization* as a source of economic activity and as the locus of a new, trade-centered seat of power.
   - *The Crusades* as a force for the disruption of feudal life and the introduction of new ideas.
   - The rise of unifying, commerce-supporting *national states*.
   - The stimulus of the *Age of Exploration* and of the *gold* it brought into Europe.
   - The emergence of *new religious ideas* more sympathetic to business activity than Catholicism had been.
   - The *monetization of dues* within the manorial system.

Economic life

2. As a consequence of these forces, we begin to see the *separation of economic from social life*. The processes of production and distribution were no longer indistinguishably melded into the prevailing religious, social, and political customs and practices, but now began to form a sharply distinct area of life in themselves.

Enclosures

3. With the rise of the economic aspect of life, we see *deep-seated transformations* taking place. The peasant-serf is no longer bound to the land but becomes a free mobile laborer; the guildmaster is no longer hobbled by guild rules but becomes an independent entrepreneur; the lord of the land becomes (in the modern sense of the word) a landlord. The transformation was a long and often violent one, especially in the complex case of the *enclosures*.

Factors of production

4. The advent of free laborers, capitalists, and landlords, each selling his or her services on the market for land and capital and labor, made it possible to speak of the "*factors of production.*" By this was implied two things: the *physical categories* of land, labor, and capital as distinguishable agents in the production process; and the *social relationships* among laborers, landowners, and capitalists as distinct groups or classes entering the marketplace.

Wage labor

5. Central among these new relationships was that of *wage labor*. In the wage-labor relationship, a worker is paid a wage for his or her labor time, and the ownership of the entire product is vested in the hands of the employer-capitalist.

Wealth in capitalism

6. The emergence of capitalism changes the conception of wealth from objects for display or prestige into commodities that must be brought to market and sold. This necessity to sell introduces a hitherto unknown urgency into the economic system.

Profit motive

7. As part of this process of change, we find the emergence of the *profit motive* at all levels of society, not as an acquisitive drive (which may have existed for centuries), but as the pervasive necessity for all people in a *monetized society* to strive for higher incomes for economic survival.

Adam Smith's *Wealth of Nations*

8. Along with the new economic society came a new interest in the mechanism of a market society. The greatest of the early economists was *Adam Smith,* author of *The Wealth of Nations*. Essentially a philosopher, Smith turned his powerful and far-ranging inquiry to the understanding of a society of "perfect liberty" (a society of freely contracting agents).

Growth

9. In *Wealth*, Smith describes two attributes of such a society The first is its *tendency*

brought about by capitalists' *investment* in *capital equipment* as a means to higher profit.

Self-regulation

10. Smith also describes the *market mechanism.* In this mechanism, *competition* plays a key role in preventing people from exacting whatever price they please from buyers. The *market mechanism* also reveals how changing demands for goods would change the production of goods, to match that demand. Therefore, the capstone of Smith's treatise is the demonstration of the *self-regulating* nature of a competitive market, in which an "invisible hand" brings socially useful ends from selfish and private means.

Questions

1. What activities of the merchant were so disruptive to feudal life? Are business activities today also the causes of social stress?
2. Why is wage labor completely incompatible with feudalism?
3. The underdeveloped nations today often resemble the economies of antiquity or of the Middle Ages, at least insofar as their poverty and stagnation are concerned. Discuss what relevance, if any, the forces of change mentioned in this chapter have on the modernization of these areas. Are there new forces of change?
4. The leading nations in the world, so far as per capita income is concerned, are the United States, Germany, and the Scandinavian states. Among the less affluent Western nations are Greece and Portugal. Do you think this proves the validity of the Weber-Tawney thesis as to the importance of the Protestant Ethic in economic growth? Does the addition of Japan change the argument?
5. The process of monetization and commercialization was often a violent one in Europe. Do you think the Civil War, which ended slavery and displaced the southern semifeudal plantation system, could be considered part of the same transformation in America?
6. Is economic life distinctly separate from social and political life in America?
7. Do you think most people in the United States obey the profit motive? Do you know anyone who has changed his or her residence because of economic considerations? His or her profession? Do you know anyone who has deliberately chosen to change his or her time of work although it would cut their income?
8. Acquisitiveness is certainly as old as man. Can we speak of the origins of capitalism as being equally old?
9. Describe what Smith meant by the "invisible hand." What is the mechanism by which selfish interests are made compatible with—indeed, made the agent for—successful social provisioning?
10. Can you see a relation between Smith's growth model and his market model? Would the growth model work if the forces of the market did not operate?

Thinking Back, Looking Ahead

VISIONS OF THE FUTURE

Market society did not appear overnight; it took hundreds of years for market society to take hold as a dominant form of organizing economic society. Moreover, the great engine of market society—machinery and the mass production it would allow—only appears at the end of this period of "emergence," indicating that technological change itself had preconditions in the social realm, as we will see in our next chapter. In this chapter, our focus has been on the process of the emergence and appearance of new forms of social organization. This is more difficult to understand than an era in which a clear set of social relations has already been well established.

Part of the difficulty of understanding this period is that much of the process of creation also involved some destruction, like religious beliefs in the sinfulness of making money. Amidst this disarray and breaking up of existing social structures, it was very difficult to see the emergence of a new coherent entity, a "market society" with all the implications of harmony that such a phrase implies. Therefore, historical change is more difficult to grasp than more or less stationary "periods." Not until the Industrial Revolution does change become a norm, with all the disturbances we can image. Do you think that the increasing presence of automated production processes might pose a similar challenge in our time? This question takes us to our next chapter.