

## Conceptualizing Capitalism: How the Misuse of Key Concepts Impedes our Understanding of Modern Economies

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**One of the most commonly used concepts in modern humanities and social sciences, capitalism is also one of the most misunderstood. Away from politically biased takes on the subject, Geoffrey M. Hodgson proposes a new, law-based framework for understanding capitalism.**

Something happened in the eighteenth century to stimulate an unprecedented explosion in economic productivity. Around 1800, GDP *per capita* began to take off in Europe, and accelerated further upwards. In 2003 Western European GDP *per capita* was about twenty times larger than it was in 1700. World GDP *per capita* in 2003 was about eleven times larger than it was in 1700. In less than half the time, US GDP *per capita* in 2003 was about twelve times greater than it was in 1870<sup>1</sup>.

As a result of technological developments in medicine and the improved average standard of living, between 1800 and 2000 life expectancy at birth rose from a global average of about thirty years to sixty-seven years, and to more than seventy-five years in several developed countries. At the same time, global growth since 1700 has seen a widening gap between rich and poor nations.

What name do we give to the economic system that became prominent in the eighteenth century and led to such huge rises in productivity? We have no better term than ‘capitalism’ especially as the new system was driven by developments in finance and the borrowing and investment of money capital.

What changes led to an unprecedented explosion in production, innovation, and human longevity? Many argue that technology explains the take-off in output. To be sure, technology was a necessary condition of much progress, and many increases in productivity have resulted from new technologies – from steam engines to modern electronics. But technological change also requires explanation. What were the necessary conditions for the development and diffusion of these new technologies?

Property rights were necessary to provide incentives, and finance was required to purchase materials and labour power. There had to be networked communities of scientists and engineers, to scrutinize, share, and develop ideas. These communities required political conditions allowing relatively free and open enquiry, with the uncensored publication of much

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<sup>1</sup> This essay draws on material from the author’s new book *Conceptualizing Capitalism: Institutions, Evolution, Future* (University of Chicago Press, forthcoming 2015). This book won the 2014 Schumpeter Prize, awarded by the International Joseph A. Schumpeter Association.

scientific information. Addressing these necessary conditions, we are brought back to the role of institutions. Both technology and institutions must be part of the explanation of the growth explosion, along with the ideas that were developed and fostered in the changing circumstances.

A key task then is to identify the key institutions that developed in the eighteenth century and led to a huge increase in productivity. If we call the new era ‘capitalism’, then what definition of capitalism does this imply?

### **Re-assessing traditional definitions of capitalism**

Several dictionaries define capitalism simply as a system involving markets and private property. But these institutions have existed for thousands of years. Trade between tribes has existed for tens of thousands of years. Private property developed fully when legal systems in early civilizations codified rights of individual ownership and contract. If markets are defined more narrowly than trade or exchange, involving a public space where goods or services are recurrently exchanged, then we have evidence of markets (from the Bible and from Herodotus) located in Greece and the Middle East, dated to the sixth century BC. A Chinese former student of mine (Xueqi Zhang) found documentary evidence of organized markets in China about 3000 years BC.

Consequently, if we define capitalism simply as private property and markets – and even if we define those terms sharply, to mean property buttressed by a legal system (and not mere possession) and markets as organized forums of exchange (and not mere trade in general) – then capitalism has existed for up to five thousand years and was well established in ancient Greece, Rome and China. Some things must be added to the definition of capitalism to make it correspond more closely to the system that emerged in the eighteenth century.

But before we discuss these additions we can already detect the terminological problems that confound our understanding of capitalism. We need to be careful when using basic terms such as ‘property’ and ‘market’. Many economists – including the anti-capitalist Karl Marx and the pro-market Ludwig von Mises – have defined property simply in terms of use or control of an asset, neglecting the question of legally-sanctioned ownership rights. Other economists, such as the Nobel laureates Ronald Coase and Douglass North, wrote of ‘markets for ideas’ or ‘political markets’, overlooking that in these so-called ‘markets’ there is no property being traded. The widespread misuse and over-extension of basic terms impedes our understanding. More careful definitions are required.

What additional institutional criteria are needed to define capitalism? Marx argued that the employment contract was part of its essence. In the first volume of *Capital*, Marx dated the rise of wage labour and employment to England in the sixteenth century. But agricultural wage labour was well established in England two centuries earlier. Neither date locates in the seventeenth century, just before the take-off of capitalism. While widespread wage-labour is a distinctive and familiar feature of capitalism, its diffusion was too early to explain the great burst of productivity that accompanied the Industrial Revolution.

Daron Acemoglu, Douglass North, Mancur Olson, Barry Weingast and other contemporary institutional economists have claimed that capitalism depends upon ‘secure property rights’ and allegedly it took off historically when they were established in the political settlement following the British Glorious Revolution of 1688. The problem here is that property rights were relatively secure in England as early as the twelfth century, when a sophisticated legal

system emerged following the reforms of Henry II. While some English kings infamously seized property or defaulted on debts or contracts, these were relatively isolated events.

Prior to 1688, a key impediment to the rise of capitalism in England was not the 'lack of property rights' as such, but the feudal nature of an extensive system of well-established ownership rights, enjoying the support of powerful interest groups. Complex feudal obligations impeded the commodification of land and other property. The removal of these feudal restrictions was a long process, beginning before 1688 and continuing long afterwards, with the most extensive reforming activity after 1750. The 1688-focused argument concerning property rights falls down on matters of historical detail.

Joseph Schumpeter promoted a different argument. In a footnote to his *History of Economic Analysis* he wrote: 'Owing to the importance of the financial complement of capitalist production and trade, the development of the law and the practice of negotiable paper and of "created" deposits afford perhaps the best indication we have for dating the rise of capitalism.' Hence Schumpeter identified the development of a financial system as a key feature in the birth of the capitalist system proper. In particular he identified the emergence of a banking system involving negotiable instruments and the buying and selling of debt.

The neglected British economist Henry Dunning MacLeod wrote in his *Principles of Economic Philosophy* (1872): 'If we were asked – Who made the discovery which has most deeply affected the fortunes of the human race? We think, after full consideration, we might safely answer – The man who first discovered that a Debt is a Saleable Commodity.'

This prompts us to search for the key institutional changes that enabled the buying and selling of debt. The idea of selling debt was originally an anathema: debt is not a good or service but a promise. Exchanges of promissory notes involve the purchase of a promise, and originally this was not recognized as a valid contract in law: the selling of debt was not sanctioned by legal recognition of the transfer of the obligation to its purchaser. Major legislative changes were necessary to make this possible.

In the seventeenth century, the failure of common law courts to deal adequately with the negotiability of debt led businessmen to press Parliament for robust legislation. In 1704, during the reign of Queen Anne, Parliament passed 'An Act for giving like Remedy upon Promissory Notes, as is now used upon Bills of Exchange, and for the better Payment of Inland Bills of Exchange.' Significant further legislation, including another Act as late as 1758, was required to consolidate negotiability. Once negotiability was established, the capitalist financial genie was out of the bottle.

These changes in the eighteenth century were part of what historians such as Peter Dickson, Stephen Epstein, Henry Roseveare, Carl Wennerlind and others have described as the 'Financial Revolution'. This took place in the decades after the new political settlement after 1688. It was in part prompted by the state and its dependence on the private banking system to help finance the Nine Years' War (1688-97) and the War of Spanish Succession (1701-13). During this period the state administration was reformed, mainly to meet the needs of war. Financial reforms continued well into the eighteenth century, preparing the ground for the Industrial Revolution.

## **Re-affirming the role of financial institutions**

In my book *Conceptualizing Capitalism* I propose a definition of capitalism that includes private property, widespread markets, widespread employment contracts and developed financial institutions. The latter item is included for the reasons given above – capitalism is above all a system based on finance. The development of financial institutions was crucial to its birth and take-off.

Widespread employment contracts are included in the definition not because they mark the beginning of capitalism – as Marx wrongly suggested – but because their possible future replacement by widespread self-employment or worker cooperatives would change the system into something quite different.

My claim that the rise of sophisticated financial institutions marks the dawn of capitalism is not original, but why have so many economists and historians (including Marx) downplayed these vital developments?

A major part of the answer lies in the metaphors that economists and others have used to frame their basic concepts and understandings of key elements in the system. These problems were evident in Adam Smith's classic book on *The Wealth of Nations* (1776). Inspired by developments in astronomy and physics, Smith made extensive use of mechanical and physical metaphors. In business usage, then and now, the term 'capital' means money held or invested, or the money value of other assets on the balance sheet of an individual or firm. But Smith changed the meaning of 'capital' from money or money value, to the assets themselves. Capital became a physical force or thing – including machines and labour – rather than a monetary asset. This change of meaning has pervaded economics ever since and has spread into sociology with mutated terms such as 'social capital'. But 'social capital' cannot be readily owned, valued, sold or used as collateral. It is thus highly remote from the still-prevailing business meaning of capital as money or the money-value of owned assets.

In all the discussion of Thomas Piketty's celebrated book on *Capital in the Twenty-First Century* it has been rarely noted that he abandoned all these perversions of the term 'capital' and reverted to its proper meaning of money or monetizable assets. On this basis we can see that the concentrated distribution of collateralizable assets is a major generator of further inequality within capitalism.

Economists and other social scientists often think of property as a thing, rather than a legally-sanctioned right to a thing. Marx was reluctant to emphasise the crucial role of the legal system because he saw it as part of the 'superstructure' rather than of 'the economic structure ... the real foundation'. But he never defined these terms clearly. His relegation of law was partly inspired by an architectural and physical metaphor.

Other social scientists downplay the role of state law because they want categories such as property and exchange to apply to all human existence since the birth of our species. Accordingly, custom is misleadingly identified as law, even in the absence of an institutionalised judiciary or legislature. Property is treated as primarily a matter of possession or control. The economic analysis of these miss-labelled 'property rights' may bring insights on how people control assets in the absence of a developed legal system, but it is inadequate to deal with the mechanisms of authority, legitimation and legal control in modern, large-scale, complex economies.

Consequently, the understanding of the modern system that we describe as 'capitalism' requires a new approach to analysis that differs from much found in economics, sociology and Marxist theory. The underlying physical metaphors of things and forces are replaced by the

notion of an economy as an evolving, information-processing system. This system entails the generation, allocation and exchange of recognised legal rights over many kinds of asset. Because of its focus on historically specific institutions such as law, property and finance, this analysis is not intended to cover all types of economic system. Far from being a weakness, such a historical focus can strengthen such a theory and give it greater analytical power.

Marx's analysis of capitalism was historically specific but flawed in its reliance on physical metaphors and its neglect of its legal foundations. Much of mainstream economics and mainstream sociology also downplays the role of law, and furthermore attempts to be universal rather than historically specific.

### **“Legal institutionalism” and the rise of modern economy**

The proposed new approach to the analysis of capitalism can be described as ‘legal institutionalism’. It puts legal institutions and relations at the centre, seeing them as a major source of power in modern society. Among others, this approach is influenced by Marx on the question of historical specificity, by Schumpeter in regard to the central role of finance, by Friedrich Hayek on the understanding of markets as information-processing systems, and by the American institutionalist John R. Commons with respect to the foundational and constitutive role of law.

The approach of legal institutionalism is primarily analytic rather than normative, but it does illuminate some particular policy perspectives. First, because information is dispersed and hugely varied in large-scale complex economies, markets are unavoidable and the classical socialist vision of wholesale collective planning is ruled out. But post-capitalist possibilities exist through the supersession of the employment relationship by self-employment or worker cooperatives.

Second, the emphasis on the legal foundation of basic capitalist institutions, in regard to property, contract, firms and finance, suggests that the construction of effective and relatively incorrupt legal institutions is important for developing countries. While all laws depend on customary support and on acknowledgement of authority, it is unrealistic to expect that these arrangements will evolve spontaneously, apart from the intervention of the state apparatus. Historically this has never happened in large-scale, complex, modern economies.

Third, because complete futures markets for labour power are ruled out by the abolition of slavery and the adoption of employment contracts, capitalism always has missing markets. The theory of general equilibrium with missing markets tells us that in such a system a market equilibrium may be Pareto suboptimal. Furthermore, when markets are incomplete, opening new markets may make things worse rather than better.

Fourth, the primary mechanism for the extension of inequalities in income and wealth is identified as the concentration of ownership of collateralisable assets in the hands of a minority of the population. Unlike the owners of labour power, the owners of capital goods and monetary assets can use their property to borrow more money, and make still more. This puts policies to alleviate inequality at the top of the agenda.

Among both opponents and critics, few appreciate that capitalism cannot in principle be a 100 percent market system, no matter how far it tries to move in that direction. By pushing back slavery and widening wage-labor, capitalism limited markets at its core: it disallowed complete futures markets for labor power. Capitalism inescapably implies limits to the scope of markets and commodity exchange.

The birth of capitalism was stimulated by Enlightenment ideas of individual liberty and equality under the law. But rightly we lack the liberties to enslave others, trade in slaves, or enslave ourselves. We have equal legal rights to use property to produce more wealth. But the owner of labor power is placed at two indelible disadvantages, compared with the owner of non-labor assets. Because of the ban on slavery, the individual cannot be used as collateral for obtaining loans, and cannot separate himself or herself from the deployment of his or her labor in production. These are systemic limitations to the Enlightenment principles of liberty and equality that are embedded in capitalism at its core.

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