A PELICAN INTRODUCTION

Economics: The User's Guide

Ha-Joon Chang

Contents

PROLOGUE
Why Bother?
WHY DO YOU NEED TO LEARN ECONOMICS?

INTERLUDE I
How to Read This Book

PART ONE: GETTING USED TO IT

CHAPTER 1
Life, the Universe and Everything
WHAT IS ECONOMICS?

CHAPTER 2
From Pin to PIN
CAPITALISM 1776 AND 2014

CHAPTER 3
How Have We Got Here?
A BRIEF HISTORY OF CAPITALISM

CHAPTER 4
Let a Hundred Flowers Bloom
HOW TO 'DO' ECONOMICS

CHAPTER 5
Dramatis Personae
WHO ARE THE ECONOMIC ACTORS?

INTERLUDE II:
Moving On…

Copyrighted material

PART TWO: USING IT

CHAPTER 6
How Many Do You Want It to Be?
OUTPUT, INCOME AND HAPPINESS

CHAPTER 7
How Does Your Garden Grow?
THE WORLD OF PRODUCTION

CHAPTER 8
Trouble at the Fidelity Fiduciary Bank
FINANCE

CHAPTER 9
Boris's Goat Should Drop Dead
INEQUALITY AND POVERTY

CHAPTER 10
I've Known a Few People Who've Worked
WORK AND UNEMPLOYMENT

CHAPTER 11
Leviathan or the Philosopher King?
THE ROLE OF THE STATE

CHAPTER 12
'All Things in Prolific Abundance'
THE INTERNATIONAL DIMENSION

EPILOGUE
What Now?
HOW CAN WE USE ECONOMICS TO MAKE OUR ECONOMY BETTER?

NOTES

ACKNOWLEDGEMENTS

Copyrighted material

FOLLOW PENGUIN

Copyrighted material

To my parents

Copyrighted material

PROLOGUE

Why Bother?

WHY DO YOU NEED TO LEARN ECONOMICS?

Why Are People Not Very Interested in Economics?

Since you have picked up this book, you probably have at least a passing interest in economics. Even so, you may be reading this with some trepidation. Economics is supposed to be difficult – perhaps not physics-difficult but demanding enough. Some of you may remember hearing an economist on the radio making an argument that sounded questionable but accepting it because, after all, he is the expert, and you haven't even read a proper book on economics.

But is economics really that difficult? It doesn't need to be – if it is explained in plain terms. In my previous book, *23 Things They Don't Tell You about Capitalism*, I even stuck my neck out and said that 95 per cent of economics is common sense – made to look difficult, with the use of jargons and mathematics.

Economics is not alone in appearing to be more difficult to outsiders than it really is. In any profession that involves some technical competence – be it economics, plumbing or medicine – jargons that facilitate communication within the profession make its communication with outsiders more difficult. A little more cynically, all technical professions have an incentive to make

Copyrighted material

themselves look more complicated than they really are so that they can justify the high fees their members charge for their services.

Even considering all this, economics has been uniquely successful in making the general public reluctant to engage with its territory. People express strong opinions on all sorts of things despite not having the appropriate expertise: climate change, gay marriage, the Iraq War, nuclear power stations. But when it comes to economic issues, many people are not even interested, not to speak of not having a strong opinion about them. When was the last time you had a debate on the future of the Euro, inequality in China or the future of the American manufacturing industry? These issues can have a huge impact on your life, wherever you live, by affecting, positively or negatively, your job prospects, your wage and eventually your pension, but you probably haven't thought about them seriously.

This curious state of affairs is only partly explained by the fact that economic issues lack the visceral appeals that things like love, dislocation, death and war have. It exists mainly because, especially in the last few decades, people have been led to believe that, like physics or chemistry, economics is a 'science', in which there is only one correct answer to everything; thus non-experts should simply accept the 'professional consensus' and stop thinking about it. Gregory Mankiw, the Harvard economics professor and the author of one of the most popular economics textbooks, says: 'Economists like to strike the pose of a scientist. I know, because I often do it myself. When I teach undergraduates, I very consciously describe the field of economics as a science, so no student would start the course thinking he was embarking on some squishy academic endeavor.'[1]

As it will become clearer throughout the book, however, economics can never be a science in the sense that physics or chemistry is. There are many different types of economic theory, each emphasizing different aspects of complex reality, making different moral and political value judgements and drawing different conclusions. Moreover, economic theories constantly fail to predict real-world developments even in areas on which they focus, not least because human beings have their own free will, unlike chemical molecules or physical objects.[2]

Copyrighted material

If there is no one right answer in economics, then we cannot leave it to the experts alone. This means that every responsible citizen needs to learn some economics. By this I don't mean picking up a thick textbook and absorbing one particular economic point of view. What is needed is to learn economics in such a way that one becomes aware of different types of economic arguments and develops the critical faculty to judge which argument makes most sense in a given economic circumstance and in light of which moral values and political goals (note that I am not saying 'which argument is correct'). This requires a book that discusses economics in a way that has not been tried, which I believe this book does.

How Is This Book Different?

How is this book different from other introductory books to economics?

One difference is that I take my readers seriously. And I mean it. This book will not be a digested version of some complicated eternal truth. I introduce my readers to many different ways of analysing the economy in the belief that they are perfectly capable of judging between different approaches. I do not eschew discussing the most fundamental methodological issues in economics, such as whether it can be a science or what role moral values do (and should) play in economics. Whenever possible, I try to reveal the assumptions underlying different economic theories so that readers can make their own judgements about their realism and plausibility. I also tell my readers how numbers in economics are defined and put together, urging them not to take them as something as objective as, say, the weight of an elephant or the temperature of a pot of water.* In short, I try to explain to my reader how to think, rather than what to think.

Engaging the reader at the deepest level of analysis, however, does not mean that the book is going to be difficult. There is nothing in this book that the reader cannot understand, as far as he or she has had a secondary education. All I ask of my readers is the curiosity to find out what is really going on and the patience to read through a few paragraphs at the same time.

Copyrighted material

Another critical difference with other economics books is that my book contains a lot of information on the real world. And when I say 'world', I mean it. This book provides information on many different countries. This is not to say that all countries get equal attention. But, unlike most other books in economics, the information will not be confined to one or two countries or to one type of country (say, rich countries or poor countries). Much of the information provided will be numbers: how large the world economy is, how much of it is produced by the US or Brazil, what proportions of their outputs China or the Democratic Republic of Congo invest, how long people work in Greece or Germany. But this will be complemented by qualitative information on institutional arrangements, historical backgrounds, typical policy and the like. The hope is that at the end of this book the reader can say that he or she has some feel about the way in which the economy actually works in the real world.

'And now for something completely different …'*

Copyrighted material

INTERLUDE I

How to Read This Book

I realize that not all readers are ready to spend a lot of time on this book, at least to begin with. Therefore, I suggest several different ways of reading this book, depending on how much time you think you can afford.

If you have ten minutes: Read the chapter titles and the first page of each chapter. If I am lucky, at the end of those ten minutes, you may suddenly find that you have a couple of hours to spare.

If you have a couple of hours: Read Chapters 1 and 2 and then the Epilogue. Flick through the rest.

If you have half a day: Read only the headlines – section titles and the summaries in italics that occur every few paragraphs. If you are a fast reader, you may also cram in the introductory section and the concluding remarks in each chapter.

If you have the time and the patience to read through: Please do. That will be the most effective way. And you will make me very happy. But even then you can skip bits that don't interest you much and read only the headlines in those bits.

Copyrighted material

PART ONE

Getting Used to It

Copyrighted material

CHAPTER 1

Life, the Universe and Everything

WHAT IS ECONOMICS?

What is economics?

A reader who is not familiar with the subject might reckon that it is the study of the economy. After all, chemistry is the study of chemicals, biology is the study of living things, and sociology is the study of society, so economics must be the study of the economy.

But according to some of the most popular economics books of our time, economics is much more than that. According to them, economics is about the Ultimate Question – of 'Life, the Universe and Everything' – as in *The Hitchhiker's Guide to the Galaxy*, the cult comedy science fiction by Douglas Adams, which was made into a movie in 2005, with Martin 'The Hobbit' Freeman in the leading role.

According to Tim Harford, the *Financial Times* journalist and the author of the successful book *The Undercover Economist*,

Copyrighted material

economics is about Life – he has named his second book *The Logic of Life*.

No economist has yet claimed that economics can explain the Universe. The Universe remains, for now, the turf of physicists, whom most economists have for centuries been looking up to as their role models, in their desire to make their subject a true science.* But some economists have come close – they have claimed that economics is about 'the world'. For example, the subtitle of the second volume in Robert Frank's popular *Economic Naturalist* series is *How Economics Helps You Make Sense of Your World*.

Then there is the Everything bit. The subtitle of *Logic of Life* is *Uncovering the New Economics of Everything*. According to its subtitle, *Freakonomics* by Steven Levitt and Stephen Dubner – probably the best-known economics book of our time – is an exploration of the *Hidden Side of Everything*. Robert Frank agrees, even though he is far more modest in his claim. In the subtitle of his first *Economic Naturalist* book, he only said *Why Economics Explains* Almost *Everything* (emphasis added).

So, there we go. Economics is (almost) about Life, the Universe and Everything.†

When you think about it, this is some claim coming from a subject that has spectacularly failed in what most non-economists think is its main job – that is, explaining the economy.

In the run-up to the 2008 financial crisis, the majority of the economics profession was preaching to the world that markets are rarely wrong and that modern economics has found ways to iron out those few wrinkles that markets may have; Robert Lucas, the 1995 winner of the Nobel Prize in Economics,* had declared in 2003 that the 'problem of depression prevention has been solved'.[1] So most economists were caught completely by surprise by the 2008 global financial crisis.† Not only that, they have not been able to come up with decent solutions to the ongoing aftermaths of that crisis.

Given all this, economics seems to suffer from a serious case of megalomania – how can a subject that cannot even manage to explain its own area very well claim to explain (almost) everything?

Copyrighted material

Economics Is the Study of Rational Human Choice …

You may think I am being unfair. Aren't all these books aimed at the mass market, where competition for readership is fierce, and therefore publishers and authors are tempted to hype things up? Surely, you would think, serious academic discourses would not make such a grand claim that the subject is about 'everything'.

These titles *are* hyped up. But the point is that they are hyped up in a particular way. The hypes could have been something along the line of 'how economics explains everything about the economy', but they are instead along the lines of 'how economics can explain not just the economy but everything else as well'.

The hypes are of this particular variety because of the way in which the currently dominant school of economics, that is, the so-called Neoclassical school, defines economics. The standard Neoclassical definition of economics, the variants of which are still used, is given in the 1932 book by Lionel Robbins, *An Essay on the Nature and Significance of Economic Science*. In the book, Robbins defined economics as 'the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses'.

In this view, economics is defined by its theoretical approach, rather than its subject matter. Economics is a study of **rational choice**, that is, choice made on the basis of deliberate, systematic calculation of the maximum extent to which the ends can be met by using the inevitably scarce means. The subject matter of the calculation can be anything – marriage, having children, crime or drug addiction, as Gary Becker, the famous Chicago economist and the winner of 1992 Nobel Prize in Economics, has written about – and not just 'economic' issues, as non-economists would define them, such as jobs, money or international trade. When Becker titled his 1976 book *The Economic Approach to Human Behaviour*, he was really declaring without the hype that economics *is* about everything.

This trend of applying the so-called economic approach to everything, called by its critics 'economics imperialism', has reached its apex recently in books like *Freakonomics*. Little of *Freakonomics* is actually about economic issues as most people would define them. It talks about Japanese sumo wrestlers,

Copyrighted material

American schoolteachers, Chicago drug gangs, participants in the TV quiz show *The Weakest Link*, real estate agents and the Ku Klux Klan.

Most people would think (and the authors also admit) that none of these people, except real estate agents and drug gangs, have anything to do with economics. But, from the point of view of most economists today, how Japanese sumo wrestlers collude to help each other out or how American schoolteachers fabricate their pupils' marks to get better job assessments are as legitimate subjects of economics as whether Greece should stay in the Eurozone, how Samsung and Apple fight it out in the smartphone market or how we can reduce youth unemployment in Spain (which is over 55 per cent at the time of writing). To those economists, those 'economic' issues do not have privileged status in economics, they are just some of many things (oh, I forgot, some of everything) that economics can explain, because they define their subject in terms of its theoretical approach, rather than its subject matter.

… or Is It the Study of the Economy?

An obvious alternative definition of economics, which I have been implying, is that it is the study of the economy. But what *is* the economy?

The economy is about money – or is it?

The most intuitive answer to most readers may be that the economy is anything to do with money – not having it, earning it, spending it, running out of it, saving it, borrowing it and repaying it. This is not quite right, but it is a good starting point for thinking about the economy – and economics.

Now, when we talk of the economy being about money, we are not really talking about physical money. Physical money – be it a banknote, a gold coin or the huge, virtually immovable stones that were used as money in some Pacific islands – is only a symbol. **Money** is a symbol of what others in your society owe you, or your claim on particular amounts of the society's resources.[2]

How money and other financial claims – such as company shares, derivatives and many complex financial products, which I will explain in later chapters – are created, sold and bought is one

Copyrighted material

huge area of economics, called financial economics. These days, given the dominance of the financial industry in many countries, a lot of people equate economics with financial economics, but it is actually only a small part of economics.

Your money – or the claims you have over resources – may be generated in a number of different ways. And a lot of economics is (or should be) about those.

The most common way to get money is to have a job

The most common way to get money – unless you have been born into it – is to have a job (including being your own boss) and earn money from it. So, a lot of economics is about **jobs**. We can reflect on jobs from different perspectives.

Jobs can be understood from the point of view of the individual worker. Whether you get a job and how much you are paid for it depends on the skills you have and how many demands there are for them. You may get very high wages because you have very rare skills, like Cristiano Ronaldo, the football player. You may lose your job (or become unemployed) because someone invents a machine that can do what you do 100 times faster – as happened to Mr Bucket, Charlie's father, a toothpaste cap-screwer, in the 2005 movie version of Roald Dahl's *Charlie and the Chocolate Factory*.* Or you have to accept lower wages or worse working conditions because your company is losing money thanks to cheaper imports from, say, China. And so on. So, in order to understand jobs even at the individual level, we need to know about skills, technological innovation and international trade.

Wages and working conditions are also deeply affected by 'political' decisions to change the very scope and the characteristics of the labour market (I have put 'political' in quotation marks, as in the end the boundary between economics and politics is blurry, but that is a topic for later – see Chapter 11). The accession of the Eastern European countries to the European Union has had huge impacts on the wages and behaviours of Western European workers, by suddenly expanding the supply of workers in their labour markets. The restriction on child labour in the late nineteenth century and early twentieth centuries had the opposite effect of shrinking the boundary of the labour market – suddenly a large proportion of the potential employees were shut out of the labour market. Regulations on working hours, working

Copyrighted material

conditions and minimum wages are examples of less dramatic 'political' decisions that affect our jobs.

There are also a lot of transfers of money going on in the economy

In addition to holding down a job, you can get money through **transfers** – that is, by simply being given it. This can be either in the form of cash or 'in kind', that is, direct provision of particular goods (e.g., food) or services (e.g., primary education). Whether in cash or in kind, these transfers can be made in a number of different ways.

There are transfers made by 'people you know'. Examples include parental support for children, people taking care of elderly family members, gifts from local community members, say, for your daughter's wedding.

Then there is charitable giving, that is, transfer voluntarily made to strangers. People – sometimes individually sometimes collectively (e.g., through corporations or voluntary associations) – give to charities that help others.

In terms of its quantity, charitable giving is overshadowed in many multiples by transfers made through governments, which tax some people to subsidize others. So a lot of economics is naturally about these things – or the areas of economics known as public economics.

Even in very poor countries, there are some government schemes to give cash or goods in kind (e.g., free grains) to those who are in the worst positions (e.g., the aged, the disabled, the starving). But the richer societies, especially those in Europe, have transfer schemes that are much more comprehensive in scope and generous in amounts. This is known as the **welfare state** and is based on **progressive taxation** (those who earn more paying proportionally larger shares of their incomes in taxes) and **universal benefits** (where everyone, not just the poorest or the disabled, is entitled to a minimum income and to basic services, such as health care and education).

Resources earned or transferred get consumed in goods or services

Once you gain access to resources, whether through jobs or transfers, you consume them. As physical beings, we need to consume some minimum amount of food, clothes, energy, housing, and other **goods** to fulfil our basic needs. And then we

Copyrighted material

consume other goods for ‘higher’ mental wants – books, musical instruments, exercise equipment, TV, computers and so on. We also buy and consume **services** – a bus ride, a haircut, a dinner at a restaurant or even a holiday abroad.[3]

So a lot of economics is devoted to the study of **consumption** – how people allocate money between different types of goods and services, how they make choices between competing varieties of the same product, how they are manipulated and/or informed by advertisements, how companies spend money to build their ‘brand images’ and so on.

Ultimately goods and services have to be produced

In order to be consumed, these goods and services have to be produced in the first place – goods in farms and factories and services in offices and shops. This is the realm of **production** – an area of economics that has been rather neglected since the Neoclassical school, which puts emphasis on exchange and consumption, became dominant in the 1960s.

In standard economics textbooks, production appears as a ‘black box’, in which somehow quantities of **labour** (work by humans) and **capital** (machines and tools) are combined to produce the goods and services. There is little recognition that production is a lot more than combining some abstract quanta called labour and capital and involves getting many ‘nitty-gritty’ things right. And these are things that most readers may not normally have associated with economics, despite their crucial importance for the economy: how the factory is physically organized, how to control the workers or deal with trade unions, how to systematically improve the technologies used through research.

Most economists are very happy to leave the study of these things to ‘other people’ – engineers and business managers. But, when you think about it, production is the ultimate foundation of any economy. Indeed, the changes in the sphere of production usually have been the most powerful sources of social change. Our modern world has been made by the series of changes in technologies and institutions relating to the sphere of production that have been made since the Industrial Revolution. The economics profession, and the rest of us whose views of the

Copyrighted material

economy are informed by it, need to pay far more attention to production than currently.

Concluding Remarks: Economics as the Study of the Economy

My belief is that economics should be defined not in terms of its methodology, or theoretical approach, but in terms of its subject matter, as is the case with all other disciplines. The subject matter of economics should be the economy – which involves money, work, technology, international trade, taxes and other things that have to do with the ways in which we produce goods and services, distribute the incomes generated in the process and consume the things thus produced – rather than 'Life, the Universe and Everything' (or 'almost everything'), as many economists think.

Defining economics in this way makes this book unlike most other economics books in one fundamental way.

As they define economics in terms of its methodology, most economics books assume that there is only one right way of 'doing economics' – that is, the Neoclassical approach. The worst examples won't even tell you that there are other schools of economics than the Neoclassical one.

By defining economics in terms of the subject matter, this book highlights the fact that there are many different ways of doing economics, each with its emphases, blind spots, strengths and weaknesses. After all, what we want from economics is the best possible explanation of various economic phenomena rather than a constant 'proof' that a particular economic theory can explain not just the economy but everything.

Further Reading

R. BACKHOUSE
The Puzzle of Modern Economics: Science or Ideology?
(Cambridge: Cambridge University Press, 2012).

B. FINE AND D. MILONAKIS

Copyrighted material

From Economics Imperialism to Freakonomics: The Shifting Boundaries between Economics and the Other Social Sciences (London: Routledge, 2009).

Copyrighted material

CHAPTER 2

From Pin to PIN

CAPITALISM 1776 AND 2014

From Pin to PIN

What is the first ever thing written about in economics? Gold? Land? Banking? Or international trade?

The answer is the pin.

Not the one that you use for your credit cards. But that little metal thing that most of you do *not* use – that is, unless you have long hair and like to keep it tidy or make your own clothes.

The making of the pin is the subject of the very first chapter of what is commonly (albeit mistakenly)[1] considered to be the first economics book, namely, *An Inquiry into the Nature and Causes of the Wealth of Nations*, by Adam Smith (1723–90).

Smith starts his book by arguing that the ultimate source of increase in wealth lies in the increase in productivity through greater **division of labour**, which refers to the division of production processes into smaller, specialized parts. He argued that this increases productivity in three ways. First, by repeating the same one or two tasks, workers become good at what they do more quickly ('practice makes perfect'). Second, by specializing,

Copyrighted material

workers do not have to spend time moving – physically and mentally – between different tasks (reduction in 'transition costs'). Last, but not least, a finer breakdown of the process makes each step easier to be automated and thus be performed at superhuman speed (mechanization).

And to illustrate this point, Smith discusses how ten people dividing up the production process of making a pin and specializing in one or two of the sub-processes can produce 48,000 pins (or 4,800 pins per person) a day. Compare this to the at most 20 pins each of them can produce a day, Smith pointed out, if each individual worker performed the whole process alone.

Smith called the pin manufacture a 'trifling' example and later went on to note how more complicated the divisions of labour for other products are, but there is no denying that he lived in a time when ten people working together to make a pin was still considered cool – well, at least cool enough to front someone's would-be *magnum opus* in what then was a cutting-edge subject.

The next two and a half centuries have seen dramatic developments in technology, driven by mechanization and the use of chemical processes, not least in the pin industry. Two generations after Smith, the output per worker had nearly doubled. Following Smith's example, Charles Babbage, the nineteenth-century mathematician who is known as the conceptual father of the computer, studied pin factories in 1832.* He found that they were producing about 8,000 pins per worker a day. 150 more years of technological progress increased productivity by yet another 100 times, to 800,000 pins per worker per day, according to the 1980 study by the late Clifford Pratten, a Cambridge economist.[2]

The increase in the productivity of making the same thing, such as the pin, is only one part of the story. Today, we produce so many things that people living in Smith's time could only dream about, such as the flying machine, or could not even imagine, such as the microchip, the computer, the fibre-optic cable and numerous other technologies that we need in order to use our pin – sorry, PIN.

All Change: How the Actors and the Institutions of

Copyrighted material

Capitalism Have Changed

It is not only production technologies – or how things are made – that have changed between Adam Smith's time and ours. **Economic actors** – or those who engage in economic activities – and **economic institutions** – or the rules regarding how production and other economic activities are organized – have also gone through fundamental transformations.

The British economy in Smith's time, which he called the 'commercial society', shared some fundamental similarities with those that we find in most of today's economies. Otherwise his work would be irrelevant. Unlike most other economies of the time (the other exceptions being the Netherlands, Belgium and parts of Italy), it was already 'capitalist'.

So what is the capitalist economy, or **capitalism**? It is an economy in which production is organized in pursuit of profit, rather than for own consumption (as in **subsistence farming**, where you grow your own food) or for political obligations (as in feudal societies or in socialist economies, where political authorities, respectively aristocrats and the central planning authority, tell you what to produce).

Profit is the difference between what you earn by selling something in the market (this is known as the sales revenue, or simply **revenue**) and the **costs** of all the inputs that have gone into the production of it. In the case of the pin factory, its profit would be the difference between the revenue from selling the pins and the costs that it has incurred in making them – the steel wire that has been turned into pins, the wages for its workers, the rent for the factory building and so on.

Capitalism is organized by capitalists, or those who own **capital goods**. Capital goods are also known as the **means of production** and refer to durable inputs into the production process (for example, machines, but not, say, raw materials). In everyday usage, we also use the term 'capital' for the money invested in a business venture.*

Capitalists own the means of production either directly or, more commonly these days, indirectly by owning **shares** (or **stocks**) in a company – that is, proportional claims on the total value of the company – that own those means of production. Capitalists hire

Copyrighted material

other people on a commercial basis to operate these means of production. These people are known as **wage labourers**, or simply workers. Capitalists make profits by producing things and selling them to other people through the **market**, which is where goods and services are bought and sold. Smith believed that **competition** among sellers in the market will ensure that profit-seeking producers will produce at the lowest possible costs, thereby benefiting everyone.

However, the similarities between Smith's capitalism and today's capitalism do not stretch much beyond those basic aspects. There are huge differences between the two eras in terms of how these essential characteristics – private ownership of means of production, profit-seeking, wage employment and market exchange – are actually translated into realities.

Capitalists are different

In Adam Smith's day, most factories (and farms) were owned and run by single individual capitalists or by partnerships made up of a small number of individuals who knew and understood each other. These capitalists were usually personally involved in production – often physically on the factory floor, ordering their workers about, swearing at them and even beating them up.

Today, most factories are owned and operated by 'unnatural' persons, namely, corporations. These corporations are 'persons' only in the legal sense. They are in turn owned by a multitude of individuals, who buy shares in them and part-own them. But being a shareholder does not make you a capitalist in the classical sense. Owning 300 of Volkswagen's 300 million shares does not entitle you to fly to its factory in, say, Wolfsburg, Germany and order 'your' workers about in 'your' factory for one-millionth of their working time. Ownership of the enterprise and control of its operations are largely separated in the largest enterprises.

Today's owners in most large corporations have only **limited liabilities**. In a limited liability company (LLC) or a public limited company (PLC), if something goes wrong with the company, shareholders only lose the money invested in their shares and that is that. In Smith's time, most company owners had unlimited liabilities, which meant that when the business failed, they had to sell their own personal assets to pay back the debts, failing which

Copyrighted material

they ended up in a debtors' prison.* Smith was against the principle of limited liability. He argued that those who manage limited liability companies without owning them are playing with 'other people's money' (his phrase, and the title of a famous play and then 1991 movie, starring Danny DeVito) and thus won't be as vigilant in their management as those who have to risk everything they have.

Companies are organized very differently from in Smith's days too, whatever the ownership form. In Smith's day, most companies were small with one production site under a simple command structure made up of a few foremen and ordinary workers, and perhaps a 'caretaker' (which is what the hired manager was called then). Today, many companies are huge, often employing tens of thousands of workers or even millions of them all over the world. Walmart employs 2.1 million people, while McDonald's, including franchises,† employs around 1.8 million people. They have complicated internal structures, variously made up of divisions, profit centres, semi-autonomous units and what not, hiring people with complicated job specifications and pay grades within a complex, bureaucratic command structure.

Workers are different too

In Smith's time, most people did *not* work for capitalists as wage labourers. The majority of people still worked in agriculture even in Western Europe, where capitalism was then most advanced.[3] A small minority of them worked as wage labourers for agricultural capitalists, but most of them were either small subsistence farmers or **tenants** (those who rent land and pay a proportion of their output in return) of aristocratic **landlords**.

During this era, even many of those who worked for capitalists were not wage labourers. There were still slaves around. Like tractors or traction animals, slaves were means of production owned by capitalists, especially the plantation owners in the American South, the Caribbean, Brazil and elsewhere. It was two generations after the publication of *The Wealth of Nations* (henceforth *TWON*) that slavery was abolished in Britain (1833). It was nearly a century after *TWON* and after a bloody civil war that slavery was abolished in the US (1862). Brazil abolished it only in 1888.

While a large proportion of people who worked for capitalists

Copyrighted material

were not wage labourers, many wage labourers were people who wouldn't be allowed to become wage labourers today. They were children. Few thought that there was anything wrong with hiring children. In his 1724 book *A Tour Through the Whole Island of Great Britain*, Daniel Defoe, the author of *Robinson Crusoe*, expressed his delight at the fact that in Norwich, then a centre for cotton textiles, 'the very children after 4 or 5 years of age could everyone earn their own bread', thanks to the 1700 ban on the import of calicoes, the then prized Indian cotton textile.[4] Child labour subsequently became restricted and then banned, but that was generations after Adam Smith's death in 1790.

Today, in Britain and other rich countries, the picture is completely different.* Children are not allowed to work, except for limited hours for a limited range of things, such as paper rounds. There are no legal slaves. Of the adult workers, around 10 per cent are **self-employed** – that is, they work for themselves – 15–25 per cent work for the government, and the rest are wage labourers working for capitalists.[5]

Markets have changed

In Smith's time, markets were largely local or at most national in scope, except in key commodities that were traded internationally (e.g., sugar, slaves or spices) or a limited range of manufactured goods (e.g., silk, cotton and woollen clothes). These markets were served by numerous small-scale firms, resulting in the state that economists these days call **perfect competition**, in which no single seller can influence the price. For people from Smith's time, it would have been impossible even to imagine companies hiring over twice the then size of London's population (0.8 million in 1800) operating in territories that outnumber the then British colonial territories (around twenty) by a factor of six (McDonald's operates in over 120 countries).[6]

Today, most markets are populated, and often manipulated, by large companies. Some of them are the only supplier (**monopoly**) or, more typically, one of the few suppliers (**oligopoly**) – not just at the national level but increasingly at the global level. For example, Boeing and Airbus supply close to 90 per cent of world civilian aircrafts. Companies may also be the sole buyer (**monopsony**) or one of the few buyers (**oligopsony**).

Copyrighted material

Unlike the small companies in Adam Smith's world, monopolistic or oligopolistic firms can influence market outcomes – they have what economists call **market power**. A monopolistic firm may deliberately restrict its output to raise its prices to the point that its profit is maximized (I explain the technical points in Chapter 11 – feel free to ignore them now). Oligopolistic firms cannot manipulate their markets as much as a monopolistic firm can, but they may deliberately collude to maximize their profits by not under-cutting each other's prices – this is known as a **cartel**. As a result, most countries now have a **competition law** (sometimes called an **anti-trust law**) in order to counter such **anti-competitive behaviours** – breaking up monopolies (for example, the US government broke up AT&T, the telephone company, in 1984) and banning collusion among oligopolistic firms.

Monopsonistic and oligopsonistic firms were considered to be theoretical curiosities even a few decades ago. Today, some of them are even more important than monopolistic and oligopolistic firms in shaping our economy. Exercising their powers as one of the few buyers of certain products, sometimes on a global scale, companies like Walmart, Amazon, Tesco and Carrefour exercise great – sometimes even defining – influence on what gets produced where, who gets how big a slice of profit and what consumers buy.

Money – the financial system – has also changed[7]

We now take it for granted that countries have only one bank that issues its notes (and coins) – that is, the **central bank**, such as the US Federal Reserve Board or the Bank of Japan. In Europe in Adam Smith's day, most banks (and even some big merchants) issued their own notes.

These notes (or bills, if you are in the US) were not notes in the modern sense. Each note was issued to a particular person, had a unique value and was signed by the cashier issuing it.[8] It was only in 1759 that the Bank of England started issuing fixed-denomination notes (the £10 note in this case – the £5 note came only in 1793, three years after Adam Smith died). And it wasn't until two generations after Smith (in 1853) that fully printed notes, with no name of the payee and no signature by issuing cashiers,

Copyrighted material

consumer tastes, fight it out by increasing the efficiency in the use of given technology. Today, competition is among huge multinational companies, with the ability not only to influence prices but to redefine technologies in a short span of time (think about the battle between Apple and Samsung) and to manipulate consumer tastes through brand-image building and advertising.

However great an economic theory may be, it is specific to its time and space. To apply it fruitfully, therefore, we require a good knowledge of the technological and institutional forces that characterize the particular markets, industries and countries that we are trying to analyse with the help of the theory. This is why, if we are to understand different economic theories in their right contexts, we need to know how capitalism has evolved. This is the task we turn to in the next chapter.

Further Reading

H.-J. CHANG

Kicking Away the Ladder: Development Strategy in Historical Perspective (London: Anthem, 2002).

R. HEILBRONER AND W. MILBERG

The Making of Economic Society, 13th edition (Boston: Pearson, 2012).

G. THERBORN

The World: A Beginner's Guide (Cambridge: Polity, 2011).

Copyrighted material

CHAPTER 3

How Have We Got Here?

A BRIEF HISTORY OF CAPITALISM

> '*Mrs Lintott*: Now. How do you define history, Mr Rudge?
> *Rudge*: Can I speak freely, Miss? Without being hit?
> *Mrs Lintott*: I will protect you.
> *Rudge*: How do I define history? It's just one fucking thing after another.'
> ALAN BENNETT, *THE HISTORY BOYS*

One Fucking Thing after Another: What Use Is History?

Many readers probably feel the same way about history as young Rudge in *The History Boys* – Alan Bennett's hit play and 2006 film about a bunch of bright but underprivileged Sheffield boys trying to gain admission to Oxford to study history.

Many people consider **economic history**, or the history of how our economies have evolved, especially pointless. Do we really need to know what happened two, three centuries ago in order to know that free trade promotes economic growth, that high taxes discourage wealth creation or that cutting red tape encourages business activities? Aren't these and other economic wisdoms of our time all propositions derived from logically airtight theories and

Copyrighted material

checked against a vast amount of contemporary statistical evidence?

The majority of economists agree. Economic history used to be a compulsory subject in graduate economics training in most American universities until the 1980s, but many of them don't even offer courses in economic history any more. Among the more theoretically oriented economists, there is even a tendency to consider economic history at best as a harmless distraction, like trainspotting, and at worst as a refuge for the intellectually challenged who cannot handle 'hard' stuff like mathematics and statistics.

However, I present my readers with a brief (well, not so brief) history of capitalism because having some knowledge of that history is vital to fully understanding contemporary economic phenomena.

Life is stranger than fiction: why history matters

History affects the present – not simply because it is what came before the present but also because it (or, rather, what people think they know about it) informs people's decisions. A lot of policy recommendations are backed up by historical examples because nothing is as effective as spectacular real-life cases – successful or otherwise – in persuading people. For example, those who promote free trade always point out that Britain and then the US became the world's economic superpowers through free trade. If they realized that their version of history is incorrect (as I will show below), they might not have such conviction in their policy recommendations. They would also find it harder to persuade others.

History also forces us to question some assumptions that are taken for granted. Once you know that lots of things that cannot be bought and sold today – human beings (slaves), child labour, government offices – used to be perfectly marketable, you will stop thinking that the boundary of the 'free market' is drawn by some timeless law of science and begin to see that it can be redrawn. When you learn that the advanced capitalist economies grew the fastest in history between the 1950s and the 1970s, when there were a lot of regulations and high taxes, you will immediately become sceptical of the view that promoting growth requires cuts in taxes and red tape.

Copyrighted material

History is useful in highlighting the limits of economic theory. Life is often stranger than fiction, and history provides many successful economic experiences (at all levels – nations, companies, individuals) that cannot be tidily explained by any single economic theory. For example, if you only read things like *The Economist* or the *Wall Street Journal*, you would only hear about Singapore's free trade policy and its welcoming attitudes towards foreign investment. This may make you conclude that Singapore's economic success proves that free trade and the free market are the best for economic development – until you also learn that almost all the land in Singapore is owned by the government, 85 per cent of housing is supplied by the government-owned housing agency (the Housing Development Board) and 22 per cent of national output is produced by state-owned enterprises (the international average is around 10 per cent). There is no single type of economic theory – Neoclassical, Marxist, Keynesian, you name it – that can explain the success of this combination of free market and socialism. Examples like this should make you both more sceptical about the power of economic theory and more cautious in drawing policy conclusions from it.

Last but not least, we need to look at history because we have the moral duty to avoid 'live experiments' with people as much as possible. From the central planning in the former socialist bloc (and their 'Big Bang' transition back to capitalism), through to the disasters of 'austerity' policies in most European countries following the Great Depression, down to the failures of 'trickle-down economics' in the US and the UK during the 1980s and the 1990s, history is littered with radical policy experiments that have destroyed the lives of millions, or even tens of millions, of people. Studying history won't allow us to completely avoid mistakes in the present, but we should do our best to extract lessons from history before we formulate a policy that will affect lives.

If you have been persuaded by any of the above points, please read through the rest of the chapter, in which a lot of the historical 'facts' that you thought you knew may be challenged and thus the way you understand capitalism hopefully transformed at least a little bit.

Copyrighted material

Tortoise vs. Snails: the World Economy before Capitalism

Western Europe grew really slowly …

Capitalism started in Western Europe, especially in Britain and the Low Countries (what are Belgium and the Netherlands today) around the sixteenth and the seventeenth centuries. Why it started there – rather than, say, China or India, which had been comparable to Western Europe in their levels of economic development until then – is a subject of intense and long-running debate. Everything from the Chinese elite's disdain for practical pursuits (like commerce and industry), the discovery of the Americas and the pattern of Britain's coal deposits has been identified as the explanation. This debate need not detain us here. The fact is that capitalism developed first in Western Europe.

Before the rise of capitalism, the Western European societies, like all the other pre-capitalist societies, changed very slowly. The society was basically organized around farming, which used virtually the same technologies for centuries, with a limited degree of commerce and handicraft industries.

Between 1000 and 1500, the medieval era, **income per capita**, namely, income per person, in Western Europe grew at 0.12 per cent per year.[1] This means that income in 1500 was only 82 per cent higher than that in 1000. To put it into perspective, this is a growth that China, growing at 11 per cent a year, experienced in just six years between 2002 and 2008. This means that, in terms of material progress, one year in China today is equivalent to eighty-three years in medieval Western Europe (which were equivalent to three-and-a-half medieval lifetimes, as the average life expectancy at the time was only twenty-four years).

… but its growth was still faster than elsewhere in the world

Having said all this, growth in Western Europe was still a sprint compared to those in Asia and Eastern Europe (including Russia), which are estimated to have grown at one-third the rate (0.04 per cent). This means that their incomes were only 22 per cent higher after half a millennium. Western Europe may have been moving like a tortoise, but other parts of the world were like snails.

Copyrighted material

crops such as (cane) sugar, rubber, cotton and tobacco. Some of the New World crops were grown in Europe and beyond and became basic food items. It stretches the imagination to think of the days when the British did not have their chips, the Italians lacked tomatoes and polenta (made with maize, or sweetcorn) and the Indians, the Thais and the Koreans did not eat any chillies.

Colonialism leaves big scars

There is a long-running debate on whether capitalism could have developed without the colonial resources of the sixteenth–eighteenth centuries – precious metal to be used as money, extra food sources such as potato and sugar and industrial inputs such as cotton.[4] While there is no question that the colonizers greatly benefited from those resources, those countries would probably have developed capitalism even without them. There is no question, however, that colonialism devastated colonized societies.

Native populations were exterminated or driven on to the margins. Their land, and the resources over and under it, were taken away. Marginalization of the indigenous population has been so extensive that Evo Morales, the current president of Bolivia, elected in 2006, is only the second head of state from the indigenous population in the Americas since the Europeans arrived in 1492 (the first was Benito Juarez, the Mexican president between 1858 and 1872).

Millions of Africans – 12 million is a common estimate – were captured and shipped out as slaves by both the Europeans and the Arabs. This was not only tragedy for those who became slaves (if they survived the atrocious journey) but it also depleted many African societies of workers and destroyed their social fabric. Countries were created out of thin air, with arbitrary boundaries, affecting the internal and the international politics of those countries to this day. The fact that so many borders in Africa are straight is a testimony to that; natural borders are never straight because they are usually formed along rivers, mountain ranges and other geographical features.

Colonialism often meant the deliberate destruction of existing productive activities in the economically more advanced regions. Most importantly, in 1700, Britain banned the import of Indian

Copyrighted material

cotton textiles ('calicoes') – we encountered the event in Chapter 2 – in order to promote its own cotton textile industry, dealing a heavy blow to the Indian cotton textile industry. The industry was finished off in the mid-nineteenth century by the influx of exports from the then mechanized British cotton textile industry. As a colony, India could not use tariffs and other policy measures to protect its own producers against British imports. In 1835, Lord Bentinck, the Governor-General of the East India Company, famously reported that 'the bones of the cotton weavers are bleaching the plains of India'.[5]

1820–1870: The Industrial Revolution

The turbo-charged drive: the Industrial Revolution starts

Capitalism really took off around 1820, with a visible acceleration of economic growth all around Western Europe and then in the 'Western offshoots' in North America and Oceania. The growth acceleration was so dramatic that the half-century following 1820 is typically referred to as the Industrial Revolution.[6]

In those fifty years, per capita income in Western Europe grew at 1 per cent, a poor growth rate these days (Japan grew at that rate during the so-called 'lost decade' of the 1990s), but compared to the 0.14 per cent growth rate between 1500 and 1820, it was a turbo-charged drive.

Expect to live for seventeen years and work eighty hours a week: misery increases for some

This acceleration of growth in per capita income, however, was initially accompanied by a fall in living standards for many. Some with old skills – such as textile artisans – lost their jobs, having been replaced by machines operated by cheaper, unskilled workers, including many children. Some machines were even designed with the small sizes of children in mind. Those who were hired to work in factories, or in the small workshops that supplied inputs for them, worked long hours – seventy to eighty hours per week was the norm, and some worked more than 100 hours a week with usually only half of Sunday free.

Working conditions were extremely hazardous. Many British cotton textile workers died of lung diseases from the dust generated in the production process. The urban working class

Copyrighted material

lived in crowded conditions, sometimes fifteen to twenty people in a room. It was typical that hundreds of people shared one toilet. They died off like flies. In poor areas of Manchester, life expectancy was seventeen years[7] – 30 per cent *lower* than what it had been for the whole of Britain before the Norman Conquest, back in 1000 (then twenty- four years).

The rise of anti-capitalist movements

Given the misery that capitalism was creating, it is no wonder that various forms of anti-capitalist movements arose. Some of them merely tried to turn the clock back. The Luddites – textile artisans of England who lost their jobs to mechanized production in the 1810s – turned to destroying the machines, the immediate cause of their unemployment and the most obvious symbol of capitalist progress. Others sought to build a better, more egalitarian society through voluntary associations. Robert Owen, the Welsh businessman, tried to build a society based on communal working and living among the like-minded – rather like the Israeli kibbutz.

The most important anti-capitalist visionary was, however, Karl Marx (1818–83), the German economist and revolutionary, who spent most of his time exiled in England – his grave is in Highgate Cemetery in London. Marx labelled Owen and others like him as 'utopian socialists' for believing that a post-capitalist society can be based on idyllic communal living. Calling his own approach 'scientific socialism', he argued that the new society should build on, rather than reject, the achievements of capitalism. A socialist society should abolish private ownership in the means of production but it should preserve the large production units created by capitalism so that it can take full advantage of their high productivities. Moreover, Marx proposed that a socialist society should be run like a capitalist firm in one important respect – it should plan its economic affairs centrally, in the same way in which a capitalist firm plans all its operations centrally. This is known as **central planning**.

Marx and many of his followers – including Vladimir Lenin, the leader of the Russian Revolution – believed that a socialist society could only be created through a revolution, led by workers, given that the capitalists would not voluntarily give up what they had. However, some of his followers, known as the 'revisionists' or

Copyrighted material

social democrats, such as Eduard Bernstein and Karl Kautsky, thought that the problems of capitalism could be alleviated through the reform, rather than abolition, of capitalism through parliamentary democracy. They advocated measures like regulation of working hours and working conditions as well as the development of the welfare state.

With hindsight, it is easy to see that those reformists read the historical trend the best, as the system they advocated is what all the advanced capitalist economies have today. At the time, however, it was not obvious that workers could be made better off under capitalism, not least because there was fierce resistance to reform from most capitalists.

From around 1870, there were palpable improvements in the conditions of the working class. Wages went up. At least in Britain, the average adult wage was finally high enough to allow the workers to buy more than the bare necessities, and some workers were now working less than sixty hours a week. Life expectancy was up from thirty-six years in 1800 to forty-one years in 1860.[8] At the end of this period, there were even the beginnings of the welfare state, which started in Germany with the 1871 industrial accident insurance scheme, introduced by Otto von Bismarck, the Chancellor of the newly united Germany.

The myth of free market and free trade: How capitalism really developed

The advancement of capitalism in the Western European countries and their offshoots in the nineteenth century is often attributed to the spread of **free trade** and **free market**. It is only because the government in these countries, it is argued, did not tax or restrict international trade (free trade) and, more generally, did not interfere in the workings of the market (free market) that these countries could develop capitalism. Britain and the US are said to have forged ahead of other countries because they were the first ones to adopt the free market and, especially, free trade.

This could not be further from the truth. The government played a leading role in the early development of capitalism both in Britain and the US, as well as in other Western European countries.[9]

Britain as the pioneer of protectionism

Starting with Henry VII (1485–1509), the Tudor monarchs promoted the woollen textile industry – Europe's then hi-tech

Copyrighted material

industry, led by the Low Countries, especially Flanders – through government intervention. **Tariffs** (taxes on imports) protected the British producers from the superior Low Country producers. The British government even sponsored the poaching of skilled textile artisans, mainly from Flanders, to gain access to advanced technologies. British or American people with names like Flanders, Fleming and Flemyng are descendants of those artisans: without those policies, there wouldn't be 007 (Ian Fleming) or penicillin (Alexander Fleming); and somehow I don't think *The Simpsons* would have been as fun as it is if Ned Flanders were called Ned Lancashire. These policies continued after the Tudors, and by the eighteenth century woollen textile goods accounted for around half of Britain's export revenue. Without those export revenues, Britain would not have been able to import the food and the raw materials that it needed for the Industrial Revolution.

British government intervention was stepped up in 1721, when Robert Walpole, Britain's first prime minister,[10] launched an ambitious and wide-ranging industrial development programme. It provided tariff protection and subsidies (especially to encourage export) to 'strategic' industries. Partly thanks to Walpole's programme, Britain started to forge ahead in the second half of the eighteenth century. By the 1770s, Britain was so obviously ahead of other countries that Adam Smith saw no need for protectionism and other forms of government intervention to help British producers. However, it was only nearly a century after Smith's *TWON* – in 1860 – that Britain fully switched to free trade, when its industrial supremacy was unquestioned. At the time, Britain accounted for 20 per cent of world manufacturing output (as of 1860) and 46 per cent of world trade in manufactured goods (as of 1870), despite having only 2.5 per cent of the world population; these numbers can be put into perspective by noting that the corresponding figures for China today are 15 per cent and 14 per cent, despite its having 19 per cent of the world population.

The US as the champion of protectionism

The US case is yet more interesting. Under British colonial rule, its development of manufacturing was deliberately suppressed. It is reported that, upon hearing about the first attempts by the American colonists to engage in manufacturing, William Pitt the

Copyrighted material

and even Japan. The Latin American unequal treaties expired in the 1870s and the 1880s, but the Asian ones lasted well into the twentieth century.

The inability to protect and promote their infant industries, whether due to direct colonial rule or to unequal treaties, was a huge contributing factor to the economic retrogression in Asia and Latin America during this period, when they saw *negative* per capita income growths (at the rates of -0.1 and -0.04 per cent per year, respectively).

1870–1913: High Noon

Capitalism gets into a higher gear: the rise of mass production

The development of capitalism began to accelerate around 1870. Clusters of new technological innovations emerged between the 1860s and the 1910s, resulting in the rise of the so-called heavy and chemical industries: electrical machinery, internal combustion engines, synthetic dyes, artificial fertilizers, and so on. Unlike the technologies of the Industrial Revolution, which had been invented by practical men with good intuition, these new technologies were developed through the systematic application of scientific and engineering principles. This meant that, once something was invented, it could be replicated and improved upon very quickly.

In addition, organization of the production process was revolutionized in many industries by the invention of the **mass production system**. The use of a *moving* assembly line (conveyor belt) and interchangeable parts dramatically lowered production costs. This system of production is the backbone (if not the entirety) of our production system today, despite frequent talks of its demise since the 1980s.

New economic institutions emerge to deal with growing production scale, risk, and instability

During its 'high noon', capitalism acquired the basic institutional shape that it has today – the limited liability company, bankruptcy law, the central bank, the welfare state, labour laws and so on. These institutional shifts came about basically because of the changes in underlying technologies and politics.

Copyrighted material

Recognizing the growing need for large-scale investments, limited liability, hitherto reserved only for privileged firms, was 'generalized' – that is, granted to any firm that met some minimum conditions. Enabling unprecedented scales of investment, the limited liability company became the most powerful vehicle for capitalist development – Karl Marx, spotting its enormous potential before any self-appointed cheerleader of capitalism, called it 'capitalist production in its highest development'.

Before the 1849 British reform, the bankruptcy law focused on punishing the bankrupt businessman, with a debtors' prison in the worst case. New bankruptcy laws, introduced in the second half of the nineteenth century, gave failed businessmen a second chance by allowing them not to pay interest to creditors while they were reorganizing their business (as in Chapter 11 of the US Federal Bankruptcy Act, introduced in 1898) and by forcing the creditors to write off parts of their debts. Being a businessman became far less risky.

With larger companies came larger banks. The risk was then heightened that the failure of one bank could destabilisze the whole financial system, so central banks were set up to deal with such problems by acting as the lender of last resort, starting with the Bank of England in 1844.

With increasing socialist agitation and reformist pressures in relation to the condition of the working class, a raft of welfare and labour legislations were implemented from the 1870s: industrial accident insurance, health insurance, old age pensions and unemployment insurance. Many countries also banned the employment of younger children (typically, those under ten to twelve) and restricted the working hours of older children (initially only to twelve hours!). They also regulated the working conditions and hours of women. Unfortunately, this was done not out of chivalry but out of contempt for women. Unlike men, it was believed, women lacked full mental faculties and therefore could sign a labour contract that was disadvantageous to them – they needed to be protected from themselves. This welfare and labour legislation took the roughest edges off capitalism and made a lot of poor people's lives better – if only slightly at the beginning.

These institutional changes promoted economic growth. Limited liability and debtor-friendly bankruptcy laws reduced risk involved

Copyrighted material

in business activities, thereby encouraging wealth creation. Central banking, on the one hand, and labour and welfare legislations, on the other, also helped growth by enhancing, respectively, economic and political stability, which increased investment and thus growth. The growth rate of per capita income in Western Europe accelerated during this 'high noon' from 1 per cent during 1820–70 to 1.3 per cent during 1870–1913.

How the 'liberal' golden age was not so liberal

The 'high noon' of capitalism is often described as the first age of **globalization**, that is, the first time in which the whole world economy was integrated into one system of production and exchange. Many commentators attribute this outcome to the **liberal** economic policies adopted during this period, when there were few policy restrictions on cross-border movements of goods, capital and people. This liberalism on the international front was matched by the **laissez-faire** approach to domestic economic policy (see the box below for definitions of these terms). Allowance of maximum freedom for business, pursuit of a **balanced budget** (that is, the government spending exactly as much as it collects in taxes) and the adoption of the Gold Standard were the key ingredients, they say. Things were, however, far more complicated.

'LIBERAL': THE MOST CONFUSING TERM IN THE WORLD?

Few words have generated more confusion than the word 'liberal'. Although the term was not explicitly used until the nineteenth century, the ideas behind **liberalism** can be traced back to at least the seventeenth century, starting with thinkers like Thomas Hobbes and John Locke. The classical meaning of the term describes a position that gives priority to freedom of the individual. In economic terms, this means protecting the right of the individual to use his property as he pleases, especially to make money. In this view, the ideal government is the one that provides only the minimum conditions that are conducive to the exercise of such a right, such as law and order. Such a government (state) is known as the **minimal state**. The famous slogan among the liberals of the time was 'laissez faire' (let things be), so liberalism is also known as the laissez-faire doctrine.

Copyrighted material

Today, liberalism is usually equated with the advocacy of democracy, given its emphasis on individual political rights, including the freedom of speech. However, until the mid-twentieth century, most liberals were *not* democrats. They did reject the conservative view that tradition and social hierarchy should have priority over individual rights. But they also believed that not everyone was worthy of such rights. They thought women lacked full mental faculties and thus did not deserve the right to vote. They also insisted that poor people should not be given the right to vote, since they believed the poor would vote in politicians who would confiscate private properties. Adam Smith openly admitted that the government 'is in reality instituted for the defence of the rich against the poor, or of those who have some property against those who have none at all'.[12]

What makes it even more confusing is that, in the US, the term 'liberal' is used to describe a view that is the left-of-centre. American 'liberals', such as Ted Kennedy or Paul Krugman, would be called social democrats in Europe. In Europe, the term is reserved for people like the supporters of the German Free Democratic Party (FDP), who would be called **libertarians** in the US.

Then there is **neo-liberalism**, which has been the dominant economic view since the 1980s (see below). It is very close to, but not quite the same as, classical liberalism. Economically, it advocates the classical minimal state but with some modifications – most importantly, it accepts the central bank with note issue monopoly, while the classical liberals thought that there should be competition in the production of money too. In political terms, neo-liberals do not openly oppose democracy, as the classical liberals did. But many of them are willing to sacrifice democracy for the sake of private property and the free market.

Neo-liberalism is also known, especially in developing countries, as the **Washington Consensus** view, referring to the fact that it is strongly advocated by the three most powerful economic organizations in the world, all based in Washington, DC, namely, the US Treasury, the International Monetary Fund (IMF) and the World Bank.

The 1870–1913 period did *not* actually see universal liberalism on the international front. In the heartland of capitalism, in Western Europe and the US, trade protectionism actually increased, not decreased.

Copyrighted material

The US became even more protectionist than before following the conclusion of the Civil War in 1865. Most Western European countries that had signed FTAs in the 1860s and the 1870s did not renew them and significantly increased tariffs after their expiry (they usually had a twenty-year lifetime). This was partly to protect agriculture, which was struggling with new cheap imports from the New World (especially the US and Argentina) and Eastern Europe (Russia and Ukraine) but also to protect and promote the new heavy and chemical industries. Germany and Sweden were the best examples of this 'new protectionism' – famously called the 'marriage of iron and rye' in Germany.

When the unequal treaties they had signed upon independence expired in the 1870s and the 1880s, the Latin American countries introduced rather high protective tariffs (30–40 per cent). However, elsewhere in the 'periphery', the forced free trade we talked about earlier spread much further. European powers competed for parts of the African continent in the 'scramble for Africa', while many Asian countries were also taken as colonies (Malaysia, Singapore and Myanmar by Britain; Cambodia, Vietnam and Laos by France). The British Empire expanded enormously, backed up by its industrial might, leading to the famous saying: 'The sun never sets on the British Empire.' Countries like Germany, Belgium, the US and Japan, which had not so far engaged in much colonialism, also joined in.[13] Not for nothing is this period also known as the 'Age of Imperialism'.

The domestic front also saw a marked increase, not a decrease, in government intervention in the core capitalist countries. There was, indeed, a strong adherence to free-market doctrines in relation to fiscal policy (the balanced budget doctrine) and monetary policy (the Gold Standard). However, this period also saw an enormous increase in the role of the government: labour regulations, social welfare schemes, public investments in infrastructure (especially railways but also canals) and in education (especially the US and Germany).

The liberal golden age of 1870–1913 was thus not as liberal as we think. It was getting less liberal in the core capitalist countries, in terms of both domestic and international policies. Liberalization happened mostly in the weaker countries, but out of compulsion rather than choice – through colonialism and unequal treaties. In

Copyrighted material

by Soviet economic performance, especially given that capitalism was then on its knees, following the Great Depression of 1929.

Capitalism gets depressed: the Great Depression of 1929

The Great Depression was an even more traumatic event for the believers in capitalism than the rise of socialism. This was especially the case in the US, where the Depression started (with the infamous 1929 Wall Street crash) and which was the hardest hit by the experience. Between 1929 and 1932, US output fell by 30 per cent and unemployment increased eightfold, from 3 per cent to 24 per cent.[16] It was not until 1937 that US output regained its 1929 level. Germany and France also suffered badly, with their outputs falling by 16 per cent and 15 per cent respectively.

One influential view, propagated by neo-liberal economists, is that this large but totally manageable financial crisis was turned into a Great Depression because of the collapse in world trade caused by the ‘trade war’, prompted by the adoption of protectionism by the US through the 1930 Smoot-Hawley Tariffs. This story does not stand up to scrutiny. The tariff increase by Smoot-Hawley was not dramatic – it raised the average US industrial tariff from 37 per cent to 48 per cent. Nor did it cause a massive tariff war. Except for a few economically weak countries such as Italy and Spain, trade protectionism did not increase very much following Smoot–Hawley. Most importantly, studies show that the main reason for the collapse in international trade after 1929 was not tariff increases but the downward spiral in international demand, caused by the adherence by the governments of the core capitalist economies to the doctrine of balanced budget.[17]

After a big financial crisis like the 1929 Wall Street crash or the 2008 global financial crisis, private-sector spending falls. Debts go unpaid, which forces banks to reduce their lending. Being unable to borrow, firms and individuals cut their spending. This, in turn, reduces demands for other firms and individuals that used to sell to them (e.g., firms selling to consumers, firms selling machinery to other firms, workers selling labour services to firms). The demand level in the economy spirals down.

In this environment, the government is the only economic actor that can maintain the level of demand in the economy by spending more than it earns, that is, by running a budget deficit. However, in

Copyrighted material

PELICAN BOOKS

Published by the Penguin Group
Penguin Books Ltd, 80 Strand, London WC2R 0RL, England
Penguin Group (USA) Inc., 375 Hudson Street, New York, New York 10014, USA
Penguin Group (Canada), 90 Eglinton Avenue East, Suite 700, Toronto, Ontario, Canada M4P 2Y3 (a division of Pearson Penguin Canada Inc.)
Penguin Ireland, 25 St Stephen's Green, Dublin 2, Ireland (a division of Penguin Books Ltd)
Penguin Group (Australia), 707 Collins Street, Melbourne, Victoria 3008, Australia (a division of Pearson Australia Group Pty Ltd)
Penguin Books India Pvt Ltd, 11 Community Centre, Panchsheel Park, New Delhi – 110 017, India
Penguin Group (NZ), 67 Apollo Drive, Rosedale, Auckland 0632, New Zealand (a division of Pearson New Zealand Ltd)
Penguin Books (South Africa) (Pty) Ltd, Block D, Rosebank Office Park, 181 Jan Smuts Avenue, Parktown North, Gauteng 2193, South Africa

Penguin Books Ltd, Registered Offices: 80 Strand, London WC2R 0RL, England

First published 2014

Copyright © Ha-Joon Chang, 2014

The moral right of the author has been asserted

All rights reserved

Typeset by Jouve (UK), Milton Keynes

ISBN: 978-0-718-19704-9

www.pelicanbooks.com
www.penguin.com

Copyrighted material