

UNDERSTANDING CAPITALISM

COMPETITION, COMMAND, AND CHANGE

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THIRD EDITION





Understanding

Capitalism

COMPETITION, COMMAND, AND CHANGE

Third Edition

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New York Oxford
OXFORD UNIVERSITY PRESS
2005

Oxford University Press

Oxford New York

Auckland Bangkok Buenos Aires Cape Town Chennai
Dar es Salaam Delhi Hong Kong Istanbul Karachi Kolkata
Kuala Lumpur Madrid Melbourne Mexico City Mumbai
Nairobi São Paulo Shanghai Taipei Tokyo Toronto

Copyright © 2005 by Oxford University Press, Inc.

Published by Oxford University Press, Inc.
198 Madison Avenue, New York, New York 10016
www.oup.com

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Library of Congress Cataloging-in-Publication Data

Bowles, Samuel.

Understanding capitalism : competition, command, and change / Samuel Bowles, Richard
Edwards, and Frank Roosevelt.—3rd ed.
p. cm.

Includes bibliographical references and index.

ISBN-13: 978-0-19-513864-1 (cloth)—ISBN-13: 978-0-19-513865-8 (pbk.)

1. Economics. 2. Capitalism. 3. United States—Economic conditions. I. Edwards,
Richard, 1944- II. Roosevelt, Frank, 1938- III. Title.
HB171.5.B6937 2005
330.12'2—dc22 2004024955

Printing number: 9 8 7 6 5

Printed in the United States of America
on acid-free paper

TO LIBBY, CAROLYN, AND JINX



PREFACE

Understanding Capitalism: Competition, Command, and Change is an introduction to economics that explains how capitalism works, why it sometimes does not work as well as we would like, and how over time it not only changes its own functioning but also revolutionizes the world around us. The book does not assume that the reader has any prior knowledge of economics.

The *three-dimensional approach* to economics offered in this book focuses not just on market *competition*, as highlighted in conventional economics textbooks, but also on relationships of *command*—the exercise of power in firms, among nations, and between social groups—and on processes of historical *change*. The approach is multidisciplinary, making extensive use of examples from history, anthropology, and the other behavioral sciences as well as economics.

The core idea uniting the three dimensions of competition, command, and change is the pursuit of profits by firms. Using this central idea, we analyze competition among firms, the search for profits as the driving force of investment and technical change, and profit seeking as a source of conflict among owners, workers, governments, employers, and consumers.

The book covers the standard topics of supply and demand, market competition, imperfect competition, aggregate demand, inflation, and unemployment. In addition, we give special attention to the extraordinary dynamism and material productivity of the capitalist economy, the psychological foundations of human behavior and the importance of Adam Smith's invisible hand, technical change and the new information-based economy, global economic integration and its impact on national economies, and inequality both within and among nations. We also provide a critical evaluation of the tenets of neoclassical economics and a clear introduction to contract theory as well as to new research in behavioral, institutional, and information economics.

We titled the book *Understanding Capitalism* (rather than, say, *Understanding Economics*) to stress that our subject matter is a real economic system—not just the ideas and models of economists. Considered in this way, economic theory is a body of knowledge that, along with history, politics, sociology, and the other social sciences, can help us understand capitalism.

STRUCTURE OF THE BOOK

Part 1, “Political Economy,” introduces the three-dimensional approach to economics, explains its relationship to other approaches, develops its fundamental concepts, and summarizes some of the pertinent facts relating to life in a capitalist economy.

Part 2, “Microeconomics,” develops the theory of the firm and of markets, including the labor market, and analyzes technological change using a Schumpeterian model of dynamic monopolistic competition. Most important, it develops the analysis of profits and the profit rate that provides the integrating principle of three-dimensional economics and establishes the link between micro- and macroeconomics.

Part 3, “Macroeconomics,” deals with the workings of the economy as a whole. To provide a foundation for our study of macroeconomics, we examine inequality both within and among nations, focusing in particular on uneven development on a global scale. Here we introduce the concepts of aggregate demand and aggregate supply and explain why unemployment is a more-or-less permanent feature of capitalist labor markets. This part of the book ends with chapters on inflation and on the government’s role in the economy.

In Part 4, we conclude the book with a challenging chapter on “The Future of Capitalism,” raising questions about the adequacy of today’s institutions to address tomorrow’s problems, including environmental degradation, global inequality, and intellectual property rights and incentives in the new information-based economy.

Teachers using the book in a microeconomics course may want to assign Chapters 1–14 and Chapter 20. Those using it in a macroeconomics course might want to focus on Chapters 1–7, 10, and 14–20. For a one-semester course, Chapters 1–10 and 20 might be appropriate, while other chapters could be included as time and student interest permit.

CHANGES IN THE THIRD EDITION

This third edition of *Understanding Capitalism* is essentially a new book. The data and examples have been updated, and three entirely new chapters have been added. We take into account developments through the early years of the third millennium, including changes in economic thought as well as in global politics and economics. We list here the most important changes.

- A completely revised and expanded first chapter presents a dramatic picture of the revolutionary changes associated with capitalism over the past three centuries. Global warming and other environmental problems are given greater attention.
- As our cover suggests, the scope of the book is more global, with increasing attention given to economic forces operating on a world scale. In recognition of the fact that the U.S. is now part of a global economy, we dropped the “in the U.S. Economy” that appeared in the subtitle of the second edition.
- A new chapter addresses the behavioral foundations of economics, showing that the selfishness of the conventionally assumed “economic man” leaves out the important

role of more social motives and explaining how individuals' tastes and values evolve in response to their experiences.

- Inequality—especially its growth in the U.S.—is a more central focus of the book. A new chapter deals with the increasing inequality of income and wealth along lines of race and gender. We also document the way that economic success (and poverty) is passed on from parents to children.
- The information revolution and the importance of technological change in general are given greater attention in this edition. In the final chapter we ask whether the growing role of information in the economy is generating pressure for change in the institutions of the capitalist economy.

PEDAGOGICAL AIDS AND SUPPLEMENTS

The glossary, the definitions of terms placed in the text margins, and the captions under each figure will assist readers in mastering the basic language and analytical tools of economics. The boxes in the text present additional facts about the economy and raise issues that can be the basis of classroom discussions.

The “Sources of Economic Information” section near the beginning of the book can help readers locate economic information from official and other sources, both in print and online.

THREE-DIMENSIONAL ECONOMICS AND THE NEOCLASSICAL PARADIGM

When the first edition of this book was published in 1985, many thought of it as an “alternative text” and welcomed it as a counterpoint to the neoclassical paradigm that was the dominant approach to economics at the time. Since that time, economics has changed in significant ways. Many of the themes central to this book are now addressed by many economists as well as by other social scientists. In recent years economists have turned their attention to the problem of inequality, the importance of ethical values and unselfish motives in economic behavior, the exercise of power, the way that history shapes economic events, and how the economy shapes who we are as individuals and as people in societies and cultures. The rapid pace of economic, scientific, political, and other developments in today's world has forced economists to face the issue of change.

Since the first edition of *Understanding Capitalism* was published, the Nobel Prize in Economics has been awarded to many of the economists who have inspired our own work. Among them are Amartya Sen and Ronald Coase (whose ideas are featured in Chapter 4), as well as George Akerlof, Joseph Stiglitz, Robert Fogel, Douglass North, Daniel Kahneman, Vernon Smith, John Nash, and others.

Of course, economics remains a controversial topic. There is, however, no longer a single dominant school but rather many distinct approaches, each with its own merits and

shortcomings. All of the Nobel Prize winners listed above have been sharp critics of some aspects of the neoclassical approach (while endorsing others). Unfortunately, the teaching of economics to undergraduates has lagged behind what is widely understood by leading economists. The conventional “neoclassical” model is still taught, often as if it were the only approach to the field. For this reason this book may still be thought of as an “alternative text” because it focuses on questions largely ignored in the standard textbooks and develops concepts and ideas that are at variance with—or not even mentioned in—conventional textbooks. In Chapter 4 we explain how our approach relates to the history of economic thought.

Samuel Bowles, *Santa Fe, New Mexico*

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Frank Roosevelt, *New York, New York*



ACKNOWLEDGMENTS

Understanding Capitalism presents an approach to teaching about economics and the economy that we have developed, along with colleagues too numerous to mention, in our introductory economics courses over three and a half decades at Harvard University, the University of Massachusetts at Amherst, and Sarah Lawrence College. To the thousands of students and dozens of teaching assistants whose criticisms, suggestions, enthusiasm, and (sometimes) indifference have guided us, we owe special thanks.

Jillian Porter and Jinx Roosevelt edited the entire text, bringing their formidable writing skills to bear on our prose. Arjun Jayadev provided the research for most of the empirical figures and suggested numerous improvements in the book based on his classroom experience with an early draft of this edition. To these three close collaborators we are greatly indebted.

Many colleagues have used previous editions of this book in their classes—or read and used drafts of the present one—and given us the kind of feedback and advice only outstanding teachers and researchers can offer. In this regard, we especially thank Frank Thompson at the University of Michigan; Martin Hart-Landsberg at Lewis and Clark College; Manuel Pastor at the University of California at Santa Cruz; Mehrene Larudee at DePaul University; Bob Pollin and David Kotz at the University of Massachusetts at Amherst; Jim Devine at Loyola Marymount University; Eric Nilsson at California State University at San Bernardino; Fritz Efaw at the University of Tennessee at Chattanooga; Eric Schutz of Rollins College; and Jeffrey Carpenter at Middlebury College. Their detailed comments and suggestions have made this a much better book.

We also thank Ed Ford at the University of South Florida and Rachel Balkom at Santa Fe Prep, who used one or another version of the book in their classes and, citing their students' responses, passed along helpful comments.

We are especially grateful to the following individuals who offered their expertise on particular sections: Dominique Alh riti re (Food and Agriculture Organization of the United Nations), Bob Allen (Oxford University), David Belkin (Independent Budget Office of the City of New York), Lourdes Beneria (Cornell University), Mike Buckner (United Mine Workers of America), Nancy Folbre (University of Massachusetts at Amherst), Victor Lippit (University of California at Riverside), Jamee Moudud (Sarah Lawrence College), Gordon Pavy (AFL-CIO), Michael Reich (University of California at Berkeley), Peter Rosset (Institute for Food and Development Policy), Juliet Schor (Boston

College), Joe Von Fischer (Princeton University), Jim Weeks (ATL International), and Edward Wolff (New York University).

Kate Boyd scanned the entire second edition of the book so that the authors could begin their work on this edition with an electronic copy of the previous one; Bae Smith at the Santa Fe Institute helped us locate many sources of information; the librarians at the Santa Fe Institute, especially Margaret Alexander and Tim Taylor, provided invaluable assistance; and Scott Gillam proofread every page of the book and offered many helpful suggestions in the weeks before it went to press.

A number of people provided other kinds of assistance at various stages of our work. For this help we specifically thank Michael Arons, Allyce Bess, John Boettiger, Mark Brenner, Marcus Feldman, Christina Fong, Sarah Knutson, Bill Mayher, Jennifer McCharen, Richard Pollak, Kenneth Pomeranz, Nick Roosevelt, and Ray Seidelman.

Last but not least, we thank the following professionals at Oxford University Press who made possible the publication of this book: Jeffrey House, our original (1998) contact with the press; the late Kenneth MacLeod, our acquiring editor; Paul Donnelly, who had faith in us over the long haul; Terry Vaughn, our very supportive and patient editor in the final year and a half; and Leslie Anglin, who shepherded the book through the process of its production.

Of course, the authors retain responsibility for any remaining errors.

Samuel Bowles, *Santa Fe, New Mexico*

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SOURCES OF ECONOMIC INFORMATION

Most of the facts in this book are taken from the following sources. Many of the information sources listed here provide extensive discussions of the data and suggestions as to where to look for further information. They are generally available online as well as in libraries.

Council of Economic Advisors, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, annual, available at <http://www.whitehouse.gov/cea/pubs.html>; past reports are at <http://gpoaccess.gov/eop/download.html>).

U.S. Bureau of the Census, *Statistical Abstract of the United States* (Washington, D.C.: U.S. Government Printing Office, annual, current edition available at <http://www.census.gov/statab/www/>).

U.S. Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970* (Washington, D.C.: U.S. Government Printing Office, 1975).

United Nations Development Programme, *Human Development Report* (New York: Oxford University Press, annual, latest edition available at <http://hdr.undp.org/reports/global/2003/>).

The World Bank, *World Development Report* (New York: Oxford University Press, annual, available at <http://econ.worldbank.org/wdr/>).

International Monetary Fund, *International Financial Statistics Yearbook: 2002* (Washington, D.C.: International Monetary Fund, 2002).

Organization for Economic Cooperation and Development, *The State of the Environment* (Paris: OECD, 1991).

Economic Policy Institute, *The State of Working America* (Ithaca, NY: ILR Press, an imprint of Cornell University Press, biannual, see link at <http://movingideas.org/>).

WorldWatch Institute, *The State of the World* (Washington, D.C.: WorldWatch Institute, annual).

In addition, a number of newspapers and periodicals provide extensive reporting on economics and the economy. Among the more informative are the *Wall Street Journal*, the *New York Times*, the *Washington Post*, the *Los Angeles Times*, *Financial Times*, *Challenge*, *Dollars and Sense*, *The Economist*, the *Milken Institute Review*, *The American Prospect*, *Business Week*, *Fortune*, and *Forbes*.

More information is contained in the fact-filled reports regularly published by the following government agencies and private organizations located in Washington, D.C.: the Congressional Budget Office, the Bureau of Economic Analysis of the U.S. Department of

Commerce, the Census Bureau of the U.S. Department of Commerce, the Bureau of Labor Statistics of the U.S. Department of Labor, the Center on Budget and Policy Priorities, the Economic Policy Institute, the Institute for Women's Policy Research, and the Urban Institute.

The Center for Popular Economics in Amherst, Mass. (www.populareconomics.org) offers both week-long courses during the summer and weekend courses at other times of the year for anyone interested in obtaining economic information and developing the skills necessary for applying economic analysis to current economic and political issues.

With the growth of the World Wide Web, there are many online sources of economic information. We provide here a selected list of Web sites where such information may be found. Because Web sites do not always have long lives, some of the sites listed may have changed their addresses or ceased to exist.

<http://www.oecd.org>

The Organization for Economic Cooperation and Development (OECD) provides data from the statistical agencies of its 20 member countries. It also develops and promotes international statistical standards and coordinates statistical activities with other international agencies.

<http://www.worldbank.org/data/onlinebases/onlinebases.html>

The World Bank offers multiple databases online, some free of charge and some on an annual subscription basis. Free access is available to a 5-year, 54-indicators segment of the World Development Indicators (WDI) database.

<http://www.imf.org/external/country/index.htm>

The International Monetary Fund (IMF) provides country-specific data, from Afghanistan to Zimbabwe.

<http://www.helsinki.fi/WebEc/webec8d.html>

Based in Helsinki, Finland, this is a master economic data source that provides links to a great number of Web sites both within the U.S. and internationally.

<http://www.census.gov/econ/www/>

This is the Web site of the U.S. Census Bureau, a subdivision of the U.S. Department of Commerce. It provides demographic as well as economic data.

<http://www.bea.gov/>

This is the Web site of the U.S. Bureau of Economic Analysis (BEA), a subdivision of the U.S. Department of Commerce. It provides a wealth of data on the U.S. economy, from gross domestic product (GDP) to U.S. investment abroad.

<http://www.bls.gov/>

This is the Web site of the U.S. Bureau of Labor Statistics (BLS), a subdivision of the U.S. Department of Labor. Information about employment, unemployment, and the unemployment rate may be found here.

<http://www.nber.org/data>

This is the Web site of the (U.S.) National Bureau of Economic Research, a private organization that is often identified as if it were an agency of the U.S. government. It offers individual-level data, industry data, and macroeconomic data (including dates for the beginnings and ends of U.S. recessions).

<http://pwt.econ.upenn.edu/>

The Penn World Tables, developed at the University of Pennsylvania, provide economic data on about 100 countries, in most cases covering the last 50 years.

<http://rfe.org/>

“Resources for Economists” is the creation of Bill Goffe, a professor of economics at the State University of New York (SUNY) at Oswego. Regularly updated, this Web site provides (as of this writing) 1,487 links (organized in 97 sections and subsections) to nearly every source of economic information on the Internet.

http://www.economics.ltsn.ac.uk/links/data_free.htm

This Web site presents data on the British economy.

<http://movingideas.org/>

This is the Web site of the “Electronic Policy Network” (EPN) sponsored by the *American Prospect* magazine. It provides links to dozens of U.S. policy-oriented organizations, from “Americans for Democratic Action” to “TomPaine.com.”

<http://www.economagic.com/>

This Web site has more than 100,000 data files, with Excel files and charts for series from such sources as the U.S. government, the Federal Reserve Bank, the Internal Revenue Service, and the European Central Bank.

<http://www.lib.umich.edu/govdocs/stats.html>

This Web site, based at the University of Michigan, has links to economics data sets on U.S. business and industry, labor, finance, price indexes and the cost of living, federal and state finances, foreign and international economics, foreign trade, gross domestic product, gross state product, and gross city product.

http://www.economy.com/dismal/toolkit_landing.asp (requires subscription)

This Web site offers daily, weekly, monthly, and quarterly economic indicators for the U.S. economy as well as for states, metropolitan areas, and zip code districts. It provides GDP figures for 176 countries, all 50 U.S. states (plus Washington, D.C., and Puerto Rico), and 318 U.S. metropolitan areas, with tables summarizing economic information broken down by geographic area. In addition, the site offers a stock market calculator as well as a way to estimate the probability of recessions in states and selected metropolitan areas.

<http://utip.gov.utexas.edu/>

This Web site, based at the University of Texas, provides data on economic inequality.

<http://www.econdata.net/>

This Web site provides U.S. regional data on demographics, employment, occupations, income, output, prices, economic assets, quality of life, industry sectors, and firm listings. It draws on numerous sources for this data, including the U.S. Bureau of Labor Statistics, the U.S. Bureau of Economic Analysis, the U.S. Census Bureau, and other government and private sources.

http://www.csufresno.edu/Economics/econ_EDL.htm

This Web site, based at California State University at Fresno, offers data sets on productivity, the labor force, income distribution, profits (“earnings”), and other variables.



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