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Capitalism: The Future of an Illusion

Fred Block, March 2014

Introduction

In 1927, Sigmund Freud, the founder of psychoanalysis, deliberately courted controversy by giving his book on religion the title, *The Future of an Illusion*. Freud argued that while religious beliefs had real and dramatic consequences, those beliefs were false; religions told made up stories that addressed some of the primal psychological conflicts of human existence. While there are still many people today who would be offended by Freud's title, it has lost its radical punch. The religious fundamentalists of the world know that they are surrounded by secular people who think their deepest beliefs are false, unproven, and illusory.

In the year 2014, however, to recycle Freud's title to suggest that capitalism is an illusion is even more heretical and outrageous than what Freud wrote in 1927. Both in the U.S. and across much of the globe, there is a broad political consensus—extending from the far right to the far left—that we are all living in a capitalist world economy. Even countries like China and Vietnam that continue to be ruled by Communist Parties are universally seen to be driven by capitalism. It seems like simple common sense that since profit oriented firms own and control most of the world's productive capacity, the world is obviously organized by a capitalist system. Why would anybody suggest that something which is so obviously true is an illusion?

Here, it is useful to go back to Freud. In suggesting that religion is an illusion, Freud did not imagine for a moment that it was unimportant. He knew that people's religious beliefs shaped their actions; he wrote his book shortly after World War I when millions had died at the front imagining that they were fighting with God on their side. A new religion that was made up by a cult leader just a few years ago can have huge consequences if he or she has sufficient followers who believe what the leader says is true. And, of course, the same thing is true of those religions that have existed for thousands of years.

This is precisely what I want to argue about capitalism. The basic idea that we live in a capitalist society emerged out of the mid-19th century writings of Karl Marx and Friedrich Engels. They were the ones who initially proposed "capitalism" as a scientific description of the type of society that was then developing in the advanced nations of Europe. At the beginning, this concept was very radical and it was rejected by respectable intellectuals. In fact, for more than a century, the concept belonged mostly to the political left—socialist and communist movements—and was used relatively sparingly by those opposed to those movements. During the Cold War, the word was so associated with Russian and Chinese denunciations of the injustices of the United States that it was avoided in polite discourse.

But as I will argue in the next chapter, this changed radically over the last half century. The term went from being highly controversial to being the common sense descriptor for the kind of society we live in that is used across the entire political spectrum. But, of course, my quarrel is not with the term itself, but rather with the baggage that comes with it. My argument is that whenever we use the word capitalism, we are instantly suggesting to the listener or the reader a set of implied ideas that are actually false and illusory.

In Through the Looking Glass, Alice has an illuminating conversation with Humpty Dumpty that is very much about the nature of words and concepts.

'And only one for birthday presents, you know. There's glory for you!'

'I don't know what you mean by "glory",' Alice said.

Humpty Dumpty smiled contemptuously. 'Of course you don't — till I tell you. I meant "there's a nice knock-down argument for you!"'

'But "glory" doesn't mean "a nice knock-down argument",' Alice objected.

'When I use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean — neither more nor less.'

'The question is,' said Alice, 'whether you can make words mean so many different things.'

'The question is,' said Humpty Dumpty, 'which is to be master — that's all.'

The serious point that Lewis Carroll is making through his imaginative nonsense is that since language is a social creation, we cannot exercise the kind of dominion over words that Humpty imagines. Words not only have definitions, they also have associations and connotations. And some words in particular, such as “capitalism” or “socialism” or “liberalism” that have been central to political debates for extended periods of time carry with them a huge amount of baggage.

When sociologists or economists or political scientists use these terms, they often propose very precise analytic definitions. But in doing so, they are being like Humpty Dumpty—imagining that they can exercise dominion over words that have acquired a life and a set of meanings of their own. The reality is that an author can provide his or her own very specific definition of “capitalism” that might take up an entire page of a text, but the reader will still plug in the meaning that has been acquired through his or her previous experiences and learning. And it is entirely possible that the meanings that the reader inserts are exactly the opposite of what the author proposes in his or her formal definition.

For example, many writers on the left seek to define “capitalism” as a specific and transitory phase of history. This was part of the Marxist argument; “capitalism” is necessary to build up humanity’s technological capacities, but then it will be pushed aside in just the same way that in earlier centuries, entire societies transitioned from “feudalism” to “capitalism”. But many of their readers have been persuaded that "capitalism" is the culmination of human history; they believe it is the most productive possible economic system and that the only alternatives are economic arrangements that would require human beings to adapt to a much lower standard of living. Such readers will simply ignore the author's attempt to make the word mean "just what I choose it to mean — neither more nor less."

Defining the Illusion

My argument is that the meanings associated with the word "capitalism" combine two quite different elements. The first are the historical meanings given to the term by socialist and communist movements ever since the middle of the 19th century. The second are the ideas of neo-classical economists that have saturated the globe in the decades since World War II. To be sure, mainstream economists in the United States, particularly, avoided the term "capitalism" until well into the 1970's. But since then, they have embraced the term and have imbued it with many of their core theoretical premises.

Before looking at those premises, it is important to emphasize how deeply mainstream economics has shaped the everyday commonsense of people who never took an economics course in their lives. One way this has happened is through a long series of best-selling books about business, particularly the kind that lay out strategies for individual career success and strategies for creating profitable business enterprises. The authors of these books almost always take neo-classical economics as a given, and then find ways to translate its insights to the business world in ways that the ordinary reader will find compelling.

Another important channel has been the way that journalists report the day-to-day news about the economy. Economic and business journalists might not have been economics majors in college, but they have had to learn enough neo-classical economics to make sense of what professional economists say and this knowledge then tends to suffuse their writing. The consequence is that they transfer to their readers some of the core insights of the neo-classical economics tradition.

Finally, there is something which is called "economic literacy" or "financial literacy" which is supposed to be part of the civic repertory of all citizens. It is especially emphasized for those in mid-life who have to think about a day where they might no longer want to or be able to hold down a job. How will they acquire enough income to support themselves during retirement? To plan for such eventualities, people need to know something about various investment instruments including particularly the stock and bond markets. In acquiring this vital information for planning their lives, people also end up as consumers of some of the core ideas of modern economics.

Through these and other channels, everyday life has become deeply influenced by the way economists think and the old left-wing term "capitalism" has taken on meanings that would leave all of the great revolutionaries rolling in their graves. To be sure, providing a full and complete distillation of what most people think when they hear the word "capitalism" would require a quite elaborate, multi-year research project. I confess that I have not done that research. Nevertheless, I still think it is possible to identify both the common shared definition and the key associations that go along with that definition.

The definition is relatively uncontroversial: capitalism is a system in which holders of private property compete on markets to maximize their profits. The first shared association is the idea that in a capitalist society, the economy is an autonomous structure that operates according to its own laws. The second is what I call the purity thesis—that this autonomous economy will work best when the autonomy is maximized, when there is the least amount of interference by other institutions, like the government, with markets. The final association is that the people in this kind of society are rational actors who are motivated primarily by material considerations, especially the desire to consume more and better goods and services.

My argument is that each of these three associations is false as a description of how economies and individuals work. My complaint about the definition is not so much that it is untrue as that it is basically useless. According to this definition, the United States, Sweden, and Zaire are all capitalist societies, so, as well, was England in 1800, but the definition does nothing to help us to understand the huge differences among these four very different types of societies. In recent years, a group of social scientists have recognized this problem and have begun to talk about "varieties of capitalism" with the argument that there are huge institutional differences across these varieties. To my mind, this is certainly an improvement; it concedes that saying that a society is capitalist does not tell us that much about how its institutions actually work.

The problem is that these analysts of the "varieties of capitalism" also suffer from the Humpty Dumpty problem; they do not address the powerful associations—autonomy, purity, rational actors--that come with the word "capitalism" and these association then undermine their efforts to explain how these different economies work.

This is the reason that I am starting with the claim of illusion. We can only get a decent understanding of how modern economies work when we discard these three associated bundles of ideas. When we get past those false ideas, we can develop an accurate understanding of how economic institutions work and that it a precondition for our being able to see how we can make them work differently and better than they have in recent years.

In a word, I am going back to Plato's allegory of the cave. The prisoners in the cave are chained so they are able to see only the shadows cast by people and things that move across the opening of the cave. They develop elaborate theories of the nature of those shadows, but those theories are wrong. It is the philosopher who escapes from the cave who is able to see the actual forms that produced the shadow who is able to provide an accurate description of reality.

Our inherited concept of "capitalism" with its core associations is a shadow on the wall of our cave. As long as we believe that shadow is reality, we remain imprisoned in a cave. In this case, the cave is a badly working set of economic institutions that generates ever rising economic and social inequality and disastrous economic crises. But if we can cast off these illusions, we will be able to see our existing economic arrangements for what they really are. We will be able to see the ways in which they have become ever more dysfunctional and we will also be able to see the path ahead to create a more just, sustainable, and prosperous economic system.

Chapter 1: The Capitalist Consensus

Over the last generation, there has been a very dramatic shift in language in the United States. In the 1960's, the word "capitalism" belonged to the far left fringe; it was not considered a polite term for describing the nation's economic system. Since the Bolshevik Revolution in 1917, and particularly after World War II, the propaganda machines of communist regimes hurled capitalism as an epithet at the U.S. and its allies to depict them as soulless societies, riven by deep inequalities, and focused only on money-making. In response, defenders of the U.S. used the label "free enterprise" to heighten the contrast between communist tyranny and freedom.

Today, however, the term capitalism has become the preferred term of the political right for defending U.S. market institutions. It is not just that conservatives accuse Obama of being a socialist; they also insist that the President does not understand the core principles of capitalism. In June of 2009, for example, more than 100 members of the House of Representatives supported a proposed Constitutional Amendment that was entitled: The Preserving Capitalism in America Amendment. This would add to the constitution a provision that would outlaw any acquisition of stock or equity in private corporations by the federal government. Similar examples can be provided endlessly.

The fact that the right has appropriated the term makes it pretty much unanimous that all relevant political factions in the U.S. believe that it is the single word that best describes our society. The views of progressives-- or those on the left of the Democratic Party—have been shaped by thinkers such as Robert Reich, Robert Kuttner, William Grieder, and Paul Krugman—all of whom matter-of-factly use the term capitalism as a label for the economic arrangements in the U.S. This is hardly surprising in that these thinkers have themselves been influenced by earlier generations of critical intellectuals—including C. Wright Mills, William Appleman Williams, Michael Harrington, and Robert Heilbroner--who used this term.

But the same matter-of-fact use of the term now also characterizes people in the center of American politics. Bill Gates, Paul Volcker, Warren Buffett, and other captains of industry and finance routinely use the term. Gates, for example, gave an influential speech in Davos in 2008 where he called for "creative capitalism" by which he meant greater emphasis by business firms on helping the poor. In a book that compiles comments on the speech from a range of people that included Larry Summers and Warren Buffett, there is much discussion of Gates' idea of "creative", but not a single person objects to Gates' use of "capitalism". (Kinsley 2008). In a word, it is now basically undisputed that the U.S. is a capitalist society. Rosa Luxemburg and V. I. Lenin would be proud that their preferred term is now the common sense of the world's leading market society.

Some might see this shift in terminology as like a change in fashion; politicians and pundits revise their rhetoric periodically just as the appropriate width for men's ties will vary over time. But this shift in language is hugely consequential because the term capitalism carries with it very substantial baggage. While most of us are largely unaware of that baggage, it still influences the way we think about our most fundamental problems and what can be done about them. The argument of this book is that the baggage associated with the word capitalism is paralyzing our politics and preventing us from seeing solutions to the multiple dangers we are confronting.

My plan is to unpack that baggage to show very specifically how conceptualizing our society as capitalist distorts our perceptions and closes off pathways that need to be opened up. But before getting to that, it is important to understand how the term capitalism became the consensus label to describe the kind of society we live in.

How the Change Occurred

Back in 1965, Paul Potter, then President of Students for a Democratic Society gave a speech at the first big student-led anti-Vietnam War march in Washington D.C. The thrust of the speech was that the Vietnam War was not an accident, but it was the logical outcome of an entire system. The crux of the speech went as follows:

"What kind of system is it that allows good men to make those kinds of decisions? What kind of system is it that justifies the United States or any country seizing the destinies of the Vietnamese people and using them callously for its own purpose? What kind of system is it that disenfranchises people in the South, leaves millions upon millions of people throughout the country impoverished and excluded from the mainstream and promise of American society, that creates faceless and terrible bureaucracies and makes those the place where people spend their lives and do their work, that consistently puts material values before human values and still persists in calling itself free and still persists in finding itself fit to police the world? What place is there for ordinary men in that system and how are they to control it, make it bend itself to their wills rather than bending them to its?

We must name that system. We must name it, describe it, analyze it, understand it and change it. For it is only when that system is changed and brought under control that there can be any hope for stopping the forces that create a war in Vietnam today or a murder in the South tomorrow or all the incalculable, innumerable more subtle atrocities that are worked on people all over—all the time."

I was a college freshman at the time and I was at that march. I remember the excitement we felt when he uttered the imperative to name the system. We all knew that he was talking about capitalism, but the term was still so strongly associated with the Old Left that Potter did not actually utter the word. But we shared his conviction that racial inequality and the Vietnam War were proof that the basic structures of U.S. society needed to be challenged and changed.

What happened between 1965 and 2010 that moved the term from the margins to the center of political discourse in the United States? Some small amount of the credit can be taken by the New Left of the 1960's and the accomplishments of scholars who were part of a revival of the Marxist tradition in universities in the 1960's and 1970's. Immanuel Wallerstein, for example, wrote a highly influential multi-volume history of the modern capitalist world system, and a group of radical economists published a popular text called, The Capitalist System. These efforts helped give the term greater intellectual legitimacy; it was no longer just a tool of Soviet propaganda. Yet the influence of these left intellectuals on the mainstream was short-lived especially as the country lurched rightward in the 1980's.

The real heavy lifting in making the term capitalism respectable was done by people on the political right. As early as 1964, Milton Friedman had called his conservative manifesto, Capitalism and Freedom and two years later Ayn Rand published a book of essays called, Capitalism: The Unknown Ideal. Both Friedman and Rand were hoping to flip the term—to strip it of its negative associations in much the same way as the Black Power movement embraced a word that had earlier conveyed stigma. But the term was still so unpopular that using it just confirmed that Friedman and Rand were intellectual figures on the far-right fringe of U.S. politics.

But others joined in and this effort to flip the term's political valance ultimately succeeded. Malcolm Forbes, publisher of Forbes Magazine, adopted the slogan for his magazine "Forbes-Capitalist Tool" in 1966. Denouncing a politician as a "capitalist tool" had long been one of the most stinging insults in the repertoire of leftist parties. By turning the phrase into an advertising slogan, Forbes was conveying the message to business people that there was no reason any longer to be defensive about being capitalists.

But probably the most important work along these lines was done by Irving Kristol, the influential neo-conservative intellectual and publicist. His Two Cheers for Capitalism published in 1978 was explicit that the term capitalism had historically belonged to opponents of the system, but he went on to argue that conservative defenders of the status quo would gain power by embracing the term. Kristol was thoroughly familiar with Marxism; he had been one of those famously disputatious Trotskyists in Alcove 1 in the City College cafeteria in the 1930's. He recognized that part of the advantage of capitalism as a term was its insistence on the systemic consequences of certain fundamental arrangements. Marx had argued that the capitalist does not seek to pursue profits because he or she is greedy or suffers some character defects. The individual capitalist does not have any choice; a failure to pursue profits will quickly end his or her business career. The relentless pursuit of profit is a structural imperative of the entire system.

What Kristol, Forbes, Friedman, and Rand recognized was that importing this concept of system into conservative thought would give it greatly increased leverage in its struggles against political liberalism. Conservatives had historically emphasized the voluntaristic and individualistic dimension of free market arrangements. They had defined a market economy as the aggregation of voluntary contracts entered into by separate individuals, and they had gone on to argue that it is desirable for both liberty and economic efficiency to allow these voluntary arrangements to operate with a minimum of "outside interference"—especially from government. But this formulation had been weakened by decades of arguments by political and legal reformers that changes in the legal rules and regulations governing private transactions are completely consistent with the principle of voluntary contracting.

For example, the reforms carried out by Franklin Roosevelt's New Deal were justified in the legal arena as being completely consistent with the idea of individuals having the freedom to engage in voluntary contracting. So, for example, incremental reforms won a series of rules governing the labor market that gave employees a variety of protections from overly long hours, inadequate wages, management's refusal to engage in collective bargaining, and dangerous and degrading work conditions. Similar reforms in consumer markets provided people protection from misleading sales practices, excessive interest rates, and dangerous products.

In the 1960's and 1970's, as consumer and environmental consciousness was growing in the U.S., this kind of incremental reform gained new momentum. Richard Nixon signed into law legislation creating new government agencies to protect the environment and protect occupational health and safety. Businesses felt that they were facing an ever stricter regulatory environment where their capacity to shift costs onto workers, customers or the environment would be severely constrained.

This is where Marx's concept of a system suddenly became so useful to conservatives. The voluntary contracting framework no longer provided protection from the steady incremental expansion of new rules and new regulations. As long as we had rules that blocked business from selling certain dangerous products, why not extend those laws to cover unsafe automobiles or toys that could hurt children? But if one argues instead that all of the individual choices that are made in the market aggregate into a coherent and cohesive system, then one is in a much stronger position to resist incremental reforms. Systems demand obedience to their organizing imperatives, and measures that are inconsistent with those imperatives can be expected to produce predictably perverse consequences. Newton's Third Law of Motion—for every action, there is an equal and opposite reaction—describes the characteristics of a system. It follows that going against the logic of the system will inevitably produce equal and opposite undesirable consequences.

In a word, Irving Kristol and other conservative intellectuals and strategists did what Marx said he had done to Hegel; stood him on his head. Marx had emphasized the systemic character of capitalism as a way to demonstrate the futility of reform proposals. He and Engels wanted radical transformation—a "root and branch" change in the form of economic organization--and their analyses and political initiatives were designed to persuade others that only a revolutionary challenge to capitalism could succeed in transforming it.

But by the time of Kristol's intervention, revolution was no longer a serious danger to existing market arrangements in the U.S. Kristol and his conservative allies were far more worried that the United States would follow the path of European social democracies with an elaborate regulatory structure and extensive public provision of social services. So they eagerly appropriated Marx's analysis to show the profound dangers of any effort to reform the "capitalist system". The irony is that Paul Potter in 1965 had urged his listeners to name the system. But once the society's intellectuals and elites had named, described, and analyzed the system as capitalism, reformist efforts were placed at a tremendous disadvantage. In fact, under the conservative hegemony that reigned from Ronald Reagan to George W. Bush, many of the incremental reforms that had been won between the 1930's and the 1970's were successfully dismantled in order to make "capitalism" work better.

The Baggage—the Autonomous Economy

But surely, contemporary market economies do have system-like qualities and it is indisputable that poorly designed policy actions can produce disastrous unintended consequences. So why object to the use of a term that has a long and distinguished intellectual lineage for drawing our attention to important regularities and interconnections? Why insist that capitalism is itself an illusion? There are two core problems—one of which will be discussed here and the second will be taken up in the next chapter. The first problem is that the term carries with it the idea that the market economy is an autonomous entity—something that is able to stand on its own and function solely by its own internal properties. This misperception or fantasy has very deep and dangerous consequences.

The economy is not something concrete and visible like Mount Everest or the Grand Canyon; it is an abstraction that encompasses some portion of human activity. Our common sense is that when the alarm goes off in the morning in our bedroom, we are in the private sphere of family life. But by the time we get to work in the morning, even if it is a home office, we have entered the sphere of the economy where we imagine that our actions and choices are shaped by considerations that are very different from those that dominate our family life. But most of us have friends at the workplace and we also participate there in social rituals such as celebrations of birthdays and retirements. So the divide between the economy and the rest of social life is not a clean one; it is ultimately an abstract distinction, albeit one that that has been part of our culture for hundreds of years.

But the Classical Political Economists at the beginning of the 19th century took an additional step. They argued that this abstract, analytical entity—the economy—is and should be—largely autonomous from other aspects of social life. This was, of course, the justification for laissez-faire or very limited government involvement in the economy. Precisely because the economy is autonomous and governed by its own internal mechanisms, such as the law of supply and demand, it must be allowed to self-regulate. Anything else will keep its internal laws from reaching the desired state of balance or equilibrium.

Ever since these early 19th century founders, the mainstream of economic thinking has been built on this idea that the economy is an autonomous entity. When pressed, most economists will acknowledge that the economy is an abstraction. But they will also say that proceeding "as if" the economy is something autonomous remains a very fruitful theoretical starting point. Just as physicist abstract away from such real world factors as friction and weather when they calculate the speed of a falling object, so assuming that the economy is autonomous allows economists to abstract away from such real world factors as culture and politics that obviously have some impact on economic behavior. But since the factors that are "internal" to the economy are the ones that are doing most of the causal work, it is okay to focus on them.

What has happened over the last thirty years with the successful redefinition of our society as being capitalist, this way of thinking characteristic of economists has now become the only way of thinking. Everybody now starts from the erroneous assumption that the economy is autonomous and is basically able to stand on its own. This is most dramatic in the case of the Right, including especially the activists of the tea party movement. In imitation of secularists, they have enunciated the principle of the separation of market and state—an idea that they believe in as deeply as many on the left and center believe in the separation of church and state.

Their view is that because the economy is a separate and autonomous and self-regulating sphere, it is incumbent on the state to stay away from it. So even actions by the government that are explicitly designed to protect private firms, such as the big Wall Street bailout engineered in the last months of the Bush Administration, are anathema. For them, the bailout constituted a moral violation of the separation of market and state, and that is why a majority of the Republicans in the House of Representatives voted against even after their party's President and Treasure Secretary pleaded that failure to approve the legislation might cause another Great Depression. One doesn't abandon deeply held moral positions just because their might be some bad consequences.

But even people on the center and left who reject the possibility of a complete separation of market and state still accept the idea that the economy is autonomous. For example, even liberals and progressives will say they favor certain types of government intervention in the economy such as environmental laws and tighter financial regulations. But that language, in itself, conveys the idea of an autonomous economy. The government is outside of the autonomous economy, so that when it enacts regulations, it is intervening in a sphere that has been operating according to its own principles.

The pitfalls in this way of thinking can be seen clearly with an engineering metaphor. Saying something is autonomous is very much like saying it has structural integrity; it can stand and operate on its own. So, for example, when the engineers come to inspect a bridge crossing a fast moving river, their job is to evaluate whether the bridge is structurally sound. Imagine if they said: "It is close to having structural integrity; let's proceed as if it were sound." That would, of course, be engineering malpractice since somebody driving a sixteen wheel tractor trailer with a heavy load needs the bridge to actually be structurally sound.

But what happened in the financial markets in 2008 was actually very similar. As Alan Greenspan said in his famous mea culpa, "I might have put too much faith in the capacity of actors in the financial markets to regulate themselves." He operated on the assumption that these markets were part of an autonomous economy that had structural integrity and could stand on its own. Imagine his surprise when the whole thing collapsed like that bridge over the Mississippi in Minneapolis that failed during rush hour in 2007 because of accumulated cracking and fatigue in the bridge's metal supports.

Yet Greenspan was simply following the logic of earlier theorists. Friedrich Hayek, one of the most influential free market theorists of the 20th century thoughts of the market economy as a spontaneous order. It was spontaneous, "because it arises out of the individual wills of the participants, without any of them needing to possess knowledge of the whole." (Gamble 38). In Hayek's own words:

The aim of the market order…is to cope with the inevitable ignorance of everybody of most of the particular facts which determine this order. By a process which men did not understand, their activities have produced an order much more extensive and comprehensive than anything they could have comprehended, but on the functioning of which we have become utterly dependent." (quoted in Gamble 38)

Describing the reality—the dependent economy

But think how strange this conceptualization is. One wouldn't argue that other social institutions are autonomous and can stand on their own. Nobody would be foolish enough to claim that the family is an autonomous, self-organizing entity. It obviously depends on the economy and has been constructed historically by religious traditions and is maintained by hundreds of specific legal arrangements. Even government which sometimes has a high degree of autonomy because of its monopoly on legitimate violence is not generally seen as freestanding; where would it be without its ability to draw revenues from economic activity? But if it is obvious foolishness to see other social institutions as freestanding and autonomous, why is this status accorded to the economy?

The answer, of course, is that it is a deeply rooted way of thinking that we have inherited from as far back as the 17th century. In arguments elaborated by John Locke, private economic contracts were seen as natural and existing before there was government. Over time, Locke's private contracting evolved into an entire economy that was conceptualized as a natural, spontaneous system of order that exists independent of government.

Economic sociologists, including myself, have tried to challenge this way of thinking by arguing that the economy is always embedded in society, politics, culture, and ideas in much the same way that coal or precious minerals are found embedded in other rocks and can only be separated with a good deal of force. But there is a problem with this metaphor—you can ultimately disembed the coal or gold and refine it down to its pure level. But you cannot disembed the economy from other institutions without destroying it. Since the economic actors themselves have been produced by a culture that instills certain ideas and beliefs, a disembedded economy would have no people in it.

Here is another metaphor. Imagine that the economy is like a huge pile of sand; it is similar to giant sand dunes at the beach. It is constantly changing shape with the winds, the tides, and in response to people and other things moving over it. The idea of building anything out of a big autonomous pile of sand is out of the question. Yes, the sand might take a shape that looks like some kind of spontaneous order, but this order will not last. However, by combining the sand with other materials—such as wood, water, soil, and lime—it can be transformed into durable structures. One can make long lasting paths by packing the sand tightly between wooden boards; one can build berms by mixing the sand with soil. Baking the sand with lime and water can produce sand-lime blocks that can be a strong and effective building material. By analogy, economic activity by itself can't build anything durable, but when combined with other materials --culture, politics, law, and ideas; economic activity can be transformed from shifting sand dunes into structures that are stable and useful.

Perhaps the best real world test of these competing ways of thinking occurred in Russia after the collapse of the Soviet system. Theorists of "shock therapy" were worried that the state's powerful role in managing the Russian economy would reassert itself in the absence of rapid initiatives to move towards a market economy. They were not concerned that the people in Russia had little familiarity with how competitive markets work. They simply assumed that if one moved quickly to privatize state-owned firms, a new spontaneous market order would quickly emerge They saw the market order as natural, so that when people were freed of the coercion of the old regime, they would quickly start doing what was natural—behaving like rational economic actors in a functioning market economy.

As the transformation began, a lot of people followed the injunction to make as much money as they could. In this sense, the shock therapists were successful in getting the new message across. But the ways in which people maximized their incomes were usually not what the theorists had in mind. The elite of the old Soviet system—the Nomenklatura—rushed to grab up ownership of state owned businesses, but very few of them settled down to run those firms as ideal typical capitalists. Some literally packed up the machine tools and other equipment in their newly owned factories, put them in trucks that crossed Russia's international border, and sold them to the highest foreign bidders. Others who gained control over valuable resources such as energy and raw material did nothing to improve production but simply raised prices as much as possible. Still others hired criminal gangs to wage war on their competitors.

In fact, instead of spontaneous order, there was an explosion of criminal activity. Kidnapping became a big business; the quickest way to make money was to grab other people and hold them for ransom. This, in turn, generated huge business opportunities for private security firms. Experienced military officers sold their services as security contractors, and it quickly became impossible to do business without hiring one or another of these firms to provide protection.

The immediate consequence of shock therapy was that the bottom fell out of the economy. The old system was dismantled, but the new market economy was basically crippled by the violence and disorder of the transition period. Unemployment levels went through the roof, those who were employed were often not paid, and barter became common because people no longer trusted the existing currency and credit was completely unavailable. The country's Gross Domestic Product fell continuously from 1991 to 1998 even after the shock therapy approach was abandoned. After 1998, the Russian economy began to grow again, fueled primarily by sales of its abundant natural resources.

Still, this prolonged crisis in the 1990's is a textbook case of the autonomous economy being little more than a disorganized sand dune. Shock therapists failed to understand that the successful market economies in Europe and North America were the product of hundreds of years of development of political, legal, cultural and ideational structures that support the functioning of productive markets. But these did not exist in Russia, so that shock therapy produced not spontaneous order but rampant disorder. Most obviously, the legal rules and enforcement systems were not in place to channel the pursuit of self-interest into the relatively narrow channel of business activity that increases the flow of goods and services. In their absence, people will make money the old fashioned way—through extortion and predation.

The Fictitious Commodities

Another way to understand how a market economy is dependent rather than autonomous is through Karl Polanyi's concept of fictitious commodities. The Hungarian social theorist argued that a market economy—and economic theory—rests on a fiction that land, labor, and money are commodities that can be bought and sold in the market like anything else. But real commodities, he insisted, are those things that were initially produced for sale on the market—a loaf of bread, a single family home, a shiny new car. But this is not the reality for land, labor, and money.

Land, he noted, is subdivided nature. With the minor exception of some low lying areas reclaimed from the sea, people have to make do with the land that geological processes created. Even when demand is extremely high, nature does not respond by creating more of it. Similarly, labor is the activity of actual human beings who were not actually produced in response to market signals. To be sure, there have been times in history where people have responded to economic improvement by having larger families, but the opposite also happens, especially when people no longer rely on their children to support them in old age. Finally, in all modern economies, the supply of money and credit is managed by central banks that try to thread the needle between tight money that cuts off economic activity and loose money that fuels inflation and asset price bubbles.

To be sure, we have elaborate systems in place to buy and sell land, labor, and money at prices that are determined by the market. However, Polanyi's point is that with real commodities, the price mechanism-- by itself--can usually balance supply and demand as, for example, when higher prices encourage producers to increase output while consumers also shift to cheaper substitutes. But since things cannot work that way with fictitious commodities, government necessarily plays an active role in coordinating the market for these key inputs into production.

In the case of land, the market has been structured by governmental rules over what types of activity are permitted in certain areas and by government provision of key infrastructure such as roads, bridges, tunnels, sewers, and water supply. It is, for example, almost always more profitable to develop land for housing rather than to use it for agriculture. So virtually all governments have pursued policies designed to keep the market mechanism from bringing about too rapid a conversion of farm land into urban and suburban developments. And when an area is designated for intensive real estate development, government facilitates this by making substantial investments in infrastructure. Similarly, within cities, different areas are zoned for different activities, so that heavy industry does not pop up right next to prime residential neighborhoods. While those business people who develop real estate at the local level might occasionally demand that government get out of their way, the reality is that government and business have to work hand-in-hand to support the market for land and new buildings.

In a parallel fashion, there are many taken-for-granted actions of government that play a critical role in balancing supply and demand in the labor market. Most important is the role that government plays in educating the labor force in an effort to avoid shortages of skills that are needed by employers. Similarly, publicly supported retirement programs help redistribute job opportunities from older workers to younger workers. In Europe in the 1980's and 1990's, for example, early retirement policies were used aggressively by governments in an effort to reduce unemployment rates. Similarly, unemployment insurance and other forms of government assistance have been consistently used to adjust the supply and demand for labor. And, of course, governments also have long used immigration and emigration policies for the same purpose.

With money, it has long been recognized that a purely private banking system cannot assure the kind of steady growth of the supply of money and credit that avoids the twin dangers of runaway booms and crippling deflations. This is why all market economies have developed central banks that attempt to regulate this supply on a daily basis. Moreover, governments also regulate private banks and other credit-creating entities for the same reason.

Finally, land, labor and money do not even exhaust the category of fictitious commodities. Knowledge—or at least the kind of knowledge that can be used by business—is yet another fictitious commodity. Patents, copyrights, or licenses to use particular types of commodified knowledge are routinely traded on markets, but they also differ fundamentally from ordinary commodities. For one thing, some of this valuable knowledge is produced as an unpredictable byproduct as scientists attempt to solve puzzles that often have nothing to do with ultimate commercial applications. For another, the protection of intellectual property creates a system of government imposed monopolies that eliminate standard competition and market clearing prices.

Here, once again, the economy cannot possibly stand on its own. Government facilitates knowledge production by investing in education, science, and technology and by developing the infrastructure of intellectual property protection. Moreover, in the last few decades, virtually all governments have significantly increased their efforts to accelerate technology development as a way to accelerate economic growth and new job creation. I have sought to show in my own work (Block and Keller 2011) that throughout U.S. history, and with increasing intensity over the last thirty years, the U.S. government has been intimately involved in technology development for commercial purposes.

Summary

The argument of this chapter is that capitalism has become the universally recognized term to describe the U.S. system of economic organization. But rather than this being a linguistic victory for the followers of Karl Marx, it represents a huge ideological win for conservative defenders of the free market. This is because the term capitalism carries with it the idea that our economy is an autonomous entity that operates according to its own inner laws. This idea of a free standing economy creates a strong barrier against government action.

While the idea of an autonomous economy has deep historical roots, it cannot be taken seriously as a description of reality. Market economies depend on government, law, culture, and ideas in a million different ways; they can no more stand on their own than a newborn baby. Russia's experience with shock therapy provides a powerful illustration that the spontaneous order of a market economy cannot just emerge by itself. Polanyi's concept of fictitious commodities shows us that many of the most important inputs into a market economy—land, labor, money, and usable knowledge—depend on ongoing and continuous action by government.

Chapter 2: The Purity Confusion

While the idea of an autonomous economy is the most important piece of baggage that is smuggled in when we use the concept of capitalism, there is a second and closely related idea that piggy backs on that first one. This is the idea of purity; if we are going to have capitalism, then it should be pure and unadulterated capitalism. Since the economy is autonomous, it doesn't make sense to fool around with some kind of messy hybrid or an impure version of capitalism because those are likely to be less productive than the real thing.

The History of the Purity Idea

Ideas of purity and impurity have deep roots in most cultures, and once this distinction becomes relevant, few people are going to admit a preference for things which are impure or corrupted. But the historical association between capitalism and purity goes back to Karl Marx. Marx was writing in the mid-19th century and was often thinking about his native Germany that was still relatively backward as compared to England's rapid industrial advance in the first decades of that century. Germany at the time was obviously some kind of weird hybrid—there were elements of modern economic development but they co-existed with many feudal remnants.

The country had not yet even been unified; it was divided into different principalities that continued to be ruled by absolute monarchs.

Marx had no ambivalence whatsoever; he wanted Germany to become modern as quickly as possible. In the view that he and Engels developed, socialism was only possible when capitalists had effectively developed the society's productive forces and had created the very large industrial labor force that would lead a revolutionary transformation. It is for this reason that parts of Marx and Engels' 1848 Communist Manifesto reads like a poem of praise to the bourgeois class that sweeps away all feudal remnants and reorganizes society along purely capitalist lines. They insist that it is only when the bourgeoisie has completed this critical task that socialism becomes a real historical possibility.

But Marx and Engels had a second reason for reinforcing the purity argument. In the 1850's and 1860's, they were advancing their vision of socialism against a variety of other political tendencies. Some of these tendencies were reformist; they wanted to win immediate changes that would modify the existing order in ways that would improve the lot of working people. Marx and Engels insisted that such reformist efforts were futile; capitalism had no choice but to exploit workers so reformist efforts were doomed to failure. There was no possibility of a kinder and gentler version of capitalism; for them it was an all or nothing proposition. In their view, mobilizations by the working class would actually make capitalism even purer until that day when the industrial working class finally had the numbers and political will to transform society completely.

This positive association between capitalism and purity carried over into the 20th century since most followers of Marx continued to deride reformists as foolish and deluded. Even after Social Democrats in Sweden had created modern social welfare institutions that significantly reduced class inequalities, many Marxists continued to insist that this strange hybrid compromise between capitalism and socialism would prove unstable and temporary—either the capitalists would reassert themselves and restore a pure version of capitalism or the working class would have to move on to real socialism to protect the reforms they had won.

But the fascinating convergence is that in the 20th century, free market intellectuals made exactly the same argument—that the only worthwhile and productive form of economic organization was a pure one that gave maximum autonomy to the market mechanism. These ideas were first elaborated in the years after World War I by two Austrian economists—Ludwig von Mises and his more famous student, Friedrich Hayek. In the years right after the Bolshevik Revolution in Russia, they were trying to explain why European societies had entered a period of deep crisis and dislocation.

To them it was obvious that World War I had led to an abrupt end to a long period of economic growth and relative stability within Europe. But what had caused the outbreak of this war? Their explanation was that the growing strength of socialist parties in Europe from the

1870's onward represented a "collectivist conspiracy" that had effectively created an impure version of capitalist society. Instead of laissez-faire and free trade, governments had responded to pressures from below by introducing regulations and tariffs and welfare measures that impaired the effectiveness of markets. The consequence was a slowdown in economic growth and the rise of jingoistic politicians who cast blame on other nations for the economic weakness that had actually been caused by compromising the purity of market institutions. For Von Mises and Hayek, this cycle was bound to repeat itself in more warfare unless the collectivist conspiracy could be defeated and truly free markets restored.

The message of the Austrians had little immediate impact because Europe was already careening towards deeper economic crisis, the rise of fascism, and renewed war. But after World War II, Von Mises and Hayek—no longer in Vienna—convened an international grouping to advance a similar line of argument. In 1947, the Mont Pelerin Society convened for the first time to argue for a restoration of a pure version of market institutions. At this point, their position was even more embattled than it had been in the 1920's since the collectivist conspiracy had gone on to new triumphs. Roosevelt's New Deal represented a dramatic break with the U.S. tradition of limited government, the Swedish Social Democrats had carried out wide ranging reforms, and even England was embracing more generous public spending. Most importantly, Keynesian economics with its support for an expanded government role in the economy was triumphant in country after country.

Nevertheless, those gathered at Mont Pelerin in 1947 and subsequent meetings kept alive the argument that these impure versions of capitalism were bound to fail—sooner or later. Most importantly, the meetings were an opportunity for the Austrians to hand the torch of free market ideas over to a new generation of thinkers—the group clustered around Milton Friedman at the University of Chicago. Friedman and his group had some significant differences with the Austrians. While the Austrians were deeply suspicious of the mathematical turn in economics, the Chicago group enthusiastically embraced the new techniques that were sweeping the field of economics. But Friedman and his group held on to the core Austrian claim that a capitalist economy works best when it is purist—closest to the ideal of a very limited government role in managing or regulating economic activity.

The Recent History of Purity

The rest of the story is now well known. Through much of the 1950's and 1960's, Friedman and the Chicago School were an embattled minority on the right wing fringe of the discipline of economics that was dominated by Keynesians. Friedman was an economic advisor to Barry Goldwater's 1964 Presidential campaign that suffered a disastrous defeat because the candidate openly called for a repeal of still popular New Deal reforms. Nevertheless, this defeat solidified a very close alliance between groups on the right of the Republican coalition, particularly Young Americans for Freedom, and Chicago School economics.

In the 1970's, the U.S. economy spluttered through years of stagflation—the combination of slow growth and high inflation. Keynesian economists were discredited by their inability to find effective responses, and the Chicago School's critique of Keynesian economic policies appeared to be vindicated. Friedman and his followers simultaneously gained greater power and legitimacy in the field of economics and in the political arena. When Reagan was elected President in 1980, Friedman's views had completed the transition from margin to mainstream.

And the story really has not changed over the last thirty-three years. The ideas of Milton Friedman and the Chicago School continue to exert tremendous influence both within the U.S. and globally. Paul Ryan, the Congressional leader who was chosen by Mitt Romney as his Vice Presidential running mate in 2012, has been a devotee throughout his career of the ideas of both the Chicago school and the Austrians. His formula for restarting economic growth in the United States is the standard Friedmanite program—reduce taxes, especially on wealth creation, cut the size of government, and reform the entitlement programs, so that individuals must take more responsibility for financing their own health care and retirement. Along the way, he also wants to reduce the power and influence of labor unions and slow the growth of state and local governments. In a word, he wants to restore a purer form of capitalism.

Moreover, this purity fixation can also be seen as underlying the global turn to austerity policies in recent years. When the Global Financial Crisis was raging in 2008 and 2009, there was a brief window when the ideas of John Maynard Keynes made a brief and dramatic comeback. The United States, most of the Europeans, China, Japan, and other nations adopted deficit-financed stimulus plans to offset the downward spiral of the global economy. While there was significant variation in the details of these stimulus plans, the general idea was that government outlays—for tax rebates, new infrastructure spending, or increased transfer payments—would bolster demand and reverse the contraction of the global economy. A simultaneous agreement to expand the issuance of Special Drawing Rights by the International Monetary Fund in 2009 was also explicitly intended to encourage governments to pursue expansionary policies rather than austerity.

However, this Keynesian moment proved very brief, indeed. It was already weakening in the final months of 2009 and it ended definitively in May 2010 when Gordon Brown, Europe's most visible Keynesian, was defeated in the UK elections. The UK led a sharp turn in favor of austerity policies by cutting spending, and over the next three years, Europe imposed painful austerity measures on the weak economies on its periphery—Ireland, Greece, Spain, Portugal, and Italy. These austerity policies rest on a variation of the purity thesis.

In a capitalist economy, it is only increased investment by the private sector that will durably spur growth. Government spending will not and cannot accomplish this end because the future tax increases needed to pay for current deficits will scare the private sector actors who must be persuaded to increase their levels of investment. In a word, deficits—no matter what the motivation—lower business confidence. Hence, the only way to recover is to restrain government spending and this necessitates austerity policies.

There is, of course, ample evidence against this argument. In the U.S., government spending on military hardware for World War II, for the Korean War, and for the Vietnam War generated a period of dynamic economic growth as increased government and consumer demand led business firms to increase their investment. Moreover, the way out of depression developed by the Swedish Social Democrats in the 1930's centered on government spending that pushed up consumer demand until business firms also increased their levels of investment.

And in fact, the track record of these recent austerity policies has not been good; government cutbacks have pushed economy after economy into slower growth and in some cases renewed recession. But these discouraging results do not seem to have much influence on the advocates of austerity. They know, after all, that they are right. It is only logical to assume that a purer form of capitalism will over the long term function more effectively than impure forms. Since stimulus policies and continuing government deficits point to increased impurity, they are undesirable even if they might produce short term benefits. So even if austerity does not improve an economy this year or next year or even the year after, it is still the right path to pursue because ultimately the superiority of the purer policy will prove itself.

Pure Capitalism vs. Democracy

The most troublesome part of the purity argument is that it leads directly to the idea that there when market institutions and political democracy come into conflict, it is democracy that needs to be restricted. After all, if we allow the market system to be compromised or impure, that will make us all poorer. But if we compromise the principle that government should be "of the people, for the people, and by the people," there will be no durable harm. In fact, it has been argued throughout the history of the United States that too much democratic governance would be a mistake, precisely because it is likely to limit the autonomy of the market system.

This issue was debated by the nation's Founders who worried that too much democracy might lead to excessive taxation and other measures that would burden the property holders whose investments were needed for future economic progress. Many of the Founders preferred to follow the English model and limit the franchise to men who owned property. When such a restriction proved untenable, the Constitution was designed to limit popular sovereignty—meaning excessive democracy—by insulating the government from the electorate. This was done by the combination of six year terms for Senators and the provision that mandated the selection of each state's senators by the state legislators. (This arrangement prevailed until 1913 when the passage of the 17th amendment to the Constitution allowed direct election of senators by the voters.) Through this mechanism the Senate would be like the English House of Lords—a mechanism to assure that property holders could slow down or block legislation that was thought to be too threatening to the autonomy of the economy.

These fears of the Founders have persisted down to the present day. In recent years, many centrist and conservative thinkers hold the view that electoral democracy contains a fatal flaw—that politicians will gain office by promising voters benefits that their society cannot possibly afford to provide. Especially when citizens are organized into pressure groups, such as employees or pension recipients, these groups can make deals in which voters trade their votes for expanded benefits. The claim is then made that the resulting "entitlements"—high wages or overly generous government benefits will discourage new investment, slow economic growth, and create the real danger of governmental bankruptcy.

This argument has become, in fact, the globally dominant viewpoint since the 2007-2009 economic downturn. Everyone knows that recovery from the Great Recession has been much slower than is typical in post-recession periods. While followers of Keynes have repeatedly argued that what the world economy needs is more stimulus, their opponents—the advocates of austerity, labeled as Austerians by Paul Krugman, have consistently been winning the policy argument. The view of the Austerians is that the reason that economies are not bouncing back is that investors are worried that governments have failed to cope with excessive levels of entitlement—overly generous pensions and other government benefits that make it highly unlikely that governments will ever be able to balance their budgets.

The Austerians insist that only those countries that are willing to take the bitter medicine of temporary austerity will create the conditions for sustainable future growth. In places such as Greece, this bitter medicine has been forced on the country despite the preferences of the Greek electorate. But the Austerians have no hesitation in overruling Greek democracy because they think that the Greek political class was irresponsible in providing voters with more benefits than Greece could possibly afford.

But the same logic is playing out in many other countries including the United States. Many in the elite share the Austerian view that the costs of the basic entitlement programs—Social Security, Medicare, and Medicaid—is unsustainable. While they know that these programs have been politically popular, here again, they blame the irresponsibility of the political class—implicating both political parties—for outbidding each other to win votes by expanding entitlements. They argue that very significant reforms of these entitlement programs are required if the U.S. is to return to a balanced federal budget and renewed economic growth. Much of the celebration of Paul Ryan, Mitt Romney's choice for the 2012 Vice Presidential candidates, as a forward looking thinker was based on his proposal to "reform" Medicare by turning it into a voucher program that would not cover all of the health care costs of those over 65. A member of the political class who was willing to tell the voters the hard truth that what they wanted is not actually affordable or practical has been treated as a hero.

We will return later to evaluate the validity of these Austerian arguments. The point here is simply to highlight that the purity principle leads directly to this idea that there is a fundamental conflict between two much democracy and the proper functioning of a market system. As with the Founders, the proposed solution is to overrule democracy by placing barriers in the way of popular sovereignty. In the case of Greece and Portugal or developing countries that have to turn to the International Monetary Fund for assistance, overruling democracy means telling the political class that they must impose austerity if they are to receive short term loans—regardless of the domestic political response.

In the United States, the proposed solutions are refinements of the Founders efforts to limit popular sovereignty. One idea—institutionalized a century ago—was to make sure that the nation's central bank—the Federal Reserve Bank—was effectively insulated from the political process. The fear was that if Congress or the President were able to exert direct influence over the Federal Reserve System, this might lead to cheap money policies that might ultimately produce inflation. As with other key appointments, the President chooses seven members of the Federal Reserve Board that then have to be confirmed by the U.S. Senate. But to insulate these appointments from politics, they are for a fourteen year period and Governors cannot be removed for their policy opinions. While the Chair and Vice-Chair are appointed for only a four year term, subject to Senate confirmation, these individuals must also be governors who are appointed to the board for the full fourteen years.

Another measure that has loomed large in recent politics is the right of members of the U.S. Senate to engage in extended debate that can only be halted through a supermajority vote—now fixed at 60 members of the Senate. Since the structure of the Senate—with two votes from each state regardless of population size—is already an affront to the principle of person, one vote, the filibuster deepens the undemocratic nature of this institution. It means that Senators from 20 and a half of the least populated states can effectively block legislation preferred by the overwhelming majority of the population that is heavily concentrated in the largest states. In fact, more than half of the population lives in just ten states, but their twenty senators are overwhelmed by the 80 senators that represent the other states.

But even these limits on democracy are seen as not yet adequate to protect the market system from voters. There has been strong support in recent years for a balanced budget amendment to the U.S. constitution that would limit government outlays to the available revenues. Such balanced budget provisions are part of the constitution of many of the U.S. states and have been institutionalized in Germany, Italy, and Switzerland. Generally, these rules allow exceptions in cases of war or other emergencies, but the mechanism is that some kind of supermajority—often placed at 2/3 of both legislative bodies—is necessary to pass an unbalanced budget. Advocates insist that this kind of restraint on the actions of the political class is necessary to block the trading of votes for budget-breaking benefits.

But once one starts down this road, where might it end? If the people cannot be trusted to elect leaders who will act responsibly, it follows that a market system requires not popular sovereignty—government of the people, by the people, for the people—but something that is better described as guided democracy. In a guided democracy, the elites—people with more money and more knowledge-- rule and the role of the people is simply to choose which elite group will run the government at a particular time. The system of guidance is designed so that the members of the elite are not tempted to pander to the populace by offering unsustainable goodies in exchange for votes.

Reprise

The concept of capitalism carries with it two critical pieces of baggage—the idea that the market system is and should be autonomous from the rest of society and that it should be kept as pure as possible. It follows logically that a capitalist democracy is an inherently contradictory and unstable institutional arrangement because the people might well choose leaders who compromise the purity and autonomy of the market system. Conservative thinkers have offered a solution to this contradiction by stressing that a written constitution, an independent judiciary and central bank, and other limits on popular sovereignty are needed to assure that a republican form of government can maintain a high functioning economic system.

Liberal and progressive thinkers have had much more difficulty thinking about this apparent contradiction. One current—we can call them "liberals"-- basically agree with the conservative diagnosis, but they disagree about the specific limitations that should be placed on popular sovereignty. Some would argue, for example, that having an undemocratically chosen Senate is a sufficient curb on democratic excess; there is no additional need to require supermajorities to pass key legislation. But another current of thought—the "progressives"-- reject the conservative diagnosis and believes that when democracy and the market system are in conflict, the people should be the ones to decide. Adherents of this position reject the idea of guided democracy and fear that eroding popular sovereignty will ultimately destroy a system of democratic governance.

Yet this second group—the progressives--are further divided in a way that undermines their ability to shape public debates. One subgroup believes unequivocally in democracy and is willing to fight for any reforms that extend and deepen popular sovereignty. We can call this group "radical democrats". But a second subgroup while equally enthusiastic about democracy believes that an expansion of popular sovereignty requires doing away with capitalism—ending the private appropriation of profits. These people are usually called socialists. The problem is that radical democrats and socialists have different strategic visions about how change can come about, so it is often difficult for them to work together or to effectively challenge their conservative and liberal opponents.

But this mapping of the political terrain all rests on the assumption that the purity idea is correct and that a market system works best when it is closest to the ideal of an autonomous and self-regulating mechanism. But what if this premise is wrong? What if it is actually impurity—a combination of different and conflicting mechanisms-- that makes a market system work effectively? What if it is precisely the combination of democratic political arrangements with a market economy that has accounted for the dramatic leaps in economic growth of the last two hundred fifty years of history?

This is precisely what I want to argue. I am claiming that the alleged contradiction between a market economy and popular sovereignty that has tormented our nation's elites since the beginning of the Republic is based on a rather deep misreading of history. The reality is that over the long term, popular sovereignty is the best and most desirable guidance mechanism to keep a market economy on track to be more productive and efficient. But this argument involves three distinct steps all of which challenge the conventional wisdom. The first is to reject the purity principle in favor of the impurity hypothesis. The second is to realize that the market system can never be autonomous from the realm of politics. And the third is the understanding that the biggest threat to the dynamism of a market economy is the entrenched power of economic elites.

So let's begin with the first step—the alternative to the purity idea is the impurity hypothesis. Fortunately, there is a long and fruitful counter-tradition that has elaborated the hypothesis that market economies work best when they are organized as compromises between opposing principles or they rest on seemingly hybrid arrangements. In this view, it is impurity that is the key to economic success. Of course, nobody argues that random mixtures of different principles and institutions would be desirable, but there have been powerful arguments for systems of institutionalized pluralism—where combinations of different principles and different institutions produce the best results. In fact, during the three decades immediately after World War II, there was a high degree of global consensus that something called a mixed economy with a large and significant state presence in the economy was the best of all possible worlds.

The Impurity Hypothesis

While exploring this counter tradition in depth would take us too far afield, it is useful to recognize a few of the key contributions to this way of thinking. One important contribution was Max Weber's (1864-1920) famous argument about the role of the protestant ethic in the rise of modern capitalism. Weber saw a significant gap in Marx's argument that the desire for greater material gain was a sufficient motivation for the emergence of the modern bourgeoisie that would significantly transform economies around the world. Weber knew that there was a very long history—going back to ancient times-- of people who pursued aggressive strategies to accumulate as much wealth as possible—exemplified by adventurers and pirates who specialized in stealing other people's shipments. He called this "adventure capitalism", but he distinguished it sharply from modern, rational capitalism. The difference was that adventure capitalists did not patiently reinvest their capital to rationalize and modernize production processes.

Weber believed that to choose the path of rational capitalism, people needed a different kind of motivation than simply wanting to accumulate a lot of wealth. Greed, by itself, ould simply make them adventurers or pirates. This was the genesis of his argument that the turn towards rational capitalism was driven by religious beliefs, specifically the denial of personal pleasure that was part of Calvinist theology. While the specifics of Weber's argument have been disputed for more than a century, there is considerable consensus that many of the individuals who built the enterprises of modern capitalism in the 17th and 18th century were deeply religious and their obedience to religious law—specifically the ten commandments—helped to channel them towards the patient accumulation of wealth through the reinvesting of profits. In short, Weber was arguing that getting the modern market system started required a complicated and impure mixture of materialist and spiritual motivations.

Joseph Schumpeter (1883-1950), one of the leading economists of the 20th century, developed a different impurity argument to cover the more recent history of market systems. Schumpeter argued that "capitalism" does not work well when the capitalists themselves are in charge of government. Such an arrangement tends to produce bad policies and heightened anti-capitalist sentiments. He argued that the best arrangement occurred when government was in the hands of "protective strata"—social groups other than the bourgeoisie and the working class. He argued that in Europe during the 19th century, the old landed elites served as a protective stratum that often dominated government positions and worked to produce policies that were not simply linked to the logic of maximizing profits. In the 20th century, he suggested that this role could be effectively played by recruits from the petit bourgeoisie—shopkeepers, artisans, and highly skilled workers.

In the second half of the 20th century, one of the most important economists to invoke an impurity argument has been the Nobel winning economist, Kenneth Arrow (b. 1921). Arrow with Gerard Debreu completed the project begun by the marginalist economists of the 19th century by working out the mathematics of a general equilibrium model in which separate markets for capital, labor, and products would be balanced by the price mechanism. But Arrow and Debreu emphasized that their model operated under very restrictive conditions that were unlikely to exist in the real world. Probably for that reason, Arrow has consistently argued that a purely market-driven system is unlikely to be the most effective and efficient way to organize society's resources. Arrow has advocated an impure system that combines a substantial role for government with the use of markets. It is part of Arrow's framework that there are some things that markets do not distribute effectively and it is precisely these things that should be provided by government.

In the middle of the 20th century, Arrow's viewpoint was widespread. Back then, the idea of the "mixed economy" was widely heralded as the best path to the future. Societies that retained a competitive marketplace could assure continuing advances in efficiency in producing important commodities. But then they would rely on government provision to make sure that other important goods were distributed in a way that was both efficient and fair. This mixed or impure economy seemed like a reasonable and pragmatic way of resolving a long debate about how best to organize society.

But when the U.S. economy encountered problems in the 1970's, that consensus in favor of impurity quickly evaporated. Milton Friedman and other proponents of the doctrine of purity gained the upper hand in debate. They had the huge advantage that the doctrine of purity could fit on a bumper sticker; all you had to say was "lower taxes, cut regulations, and shrink government" or even just "small government". In contrast, the argument for impurity required long paragraphs of boring exposition.

But look at the consequences. Now pretty much everybody believes that there is a fundamental tension between the market system and democratic institutions and that it makes sense to restrain popular sovereignty so that the market system will be protected from leaders who trade votes for political favors. It follows that international institutions such as the European Community or the International Monetary Funds should be able to impose policies on particular nations that are the opposite of what their electorates voted for. It also follows that since the voters cannot really be trusted that we might as well create more barriers to electoral participation. So, for example, in the United States, at least fourteen states have passed rules requiring that voters have a government issued identification card with a photograph.

Such laws have been passed as a deliberate partisan maneuver by Republican legislators since heavily Democratic constituencies such as young people and minority voters are significantly less likely to have that type of identification. But what is so striking is how little outrage such measures have produced either within the elite or among the public. In a nation that recently went to war to bring democracy to Iraq, one might think that the public would rise up and say that to tamper with the sacred right to vote for partisan advantage is shameful and will not be tolerated in a nation that believes deeply in democratic institutions and procedures.

Perhaps the explanation is that now that everybody thinks that we live in a capitalist society, they realize that we just cannot afford to have a full and vigorous democracy. After all, if assuring that we have jobs, homes and enough to eat requires that the mechanisms of an autonomous and pure market system are functioning properly, then maybe we have to accept some limitations on democracy. The fact that some people will be denied the vote because they lack proper photo identification might be a small price to pay for future economic prosperity.

But this is exactly wrong. When we allow democracy to be eroded, we also destroy the conditions for future prosperity. The purity argument that poses a fundamental tension between democracy and a well- functioning market system is simply wrong. As we will try to show in the next chapter, the seemingly impure blending of markets and democratic governance has been the key driver of economic dynamism in the United States for more than two centuries.