Chapter 4

# What Is Capitalism?

Before we entrust the education of the nation's roughly 47 million school-aged children to the institutions and processes of capitalism, it is valuable to review how capitalism works and what distinguishes it from other types of economic systems. The start of the twenty-first century is a good time to reevaluate long-held opinions about capitalism. The passage of time has put many beliefs to the test, and the institutions of capitalism themselves have evolved, some of them rapidly.

## A GOOD TIME TO RECONSIDER

The Soviet Union and East Germany are no more, and today's scholars now paint their histories in much darker hues than many of those who wrote in the 1960s and 1970s.[1] North Korea and Cuba, the world's last communist countries, have become hermit nations, reverting to preindustrial lifestyles and suffering poverty and malnutrition as a result.

[1]Francois Furet, *The Passing of an Illusion: The Idea of Communism in the Twentieth Century* (Chicago: University of Chicago Press, 1999); Paul Johnson, *A History of the American People* (New York: HarperCollins Publishers, Inc., 1997); Brian Crozier, *The Rise and Fall of the Soviet Empire* (Rocklin, Calif.: Prima Publishing, 1999).

Countries such as Japan, once viewed as models of communitarianism and benevolent central planning, are turning to Western-style capitalism.[2] According to a recent article, "All Japan seems to have broken into a celebration of the individual, in what Japanese are starting to call the 'era of personal responsibility.' Instead of denouncing individualism as a threat to society, people are proposing it as a necessary solution to Japan's many ills."[3]

Even Vietnam, the furnace in which many readers' political views were forged or hardened during the 1960s and 1970s, is changing. Today, "Vietnam's aging leaders [are] gradually moving the country away from the wars, isolation and Soviet-style (and once Soviet-funded) economy of the past, towards something much more like a peaceful, liberal and market-based system."[4]

On every continent, capitalism is replacing socialism as the economic model for nations pursuing peace, freedom, and prosperity. Prominent liberal writers, such as Lester Thurow, have admitted that "socialism is dead."[5] Repeated studies have shown that the civil rights records and prosperity of nations are closely and positively linked to how free their economies are from gov-

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[2]"The so-called 'convoy system,' in which government attempts to manage and protect the interest of a limited number of companies, is obsolete in a global economy where government has lost the power to control competition and where new companies and industries are created every day. As Japan moves into the twenty-first century, the government must fundamentally change its approach to competition and redefine its role in the economy. . . . A new governance system will elevate the importance of profit and encourage more distinctive strategies." Michael E. Porter, Hirotaka Takeuchi, and Mariko Sakakibara, *Can Japan Compete?* (Cambridge, Mass.: Perseus Publishing, 2000), 160–61.

[3]Yumiko Ono and Bill Spindle, "Japan's Long Decline Makes One Thing Rise: Individualism," *Wall Street Journal,* 29 December 2000, 1, A4.

[4]"Bye-bye, Uncle Ho," *The Economist,* 11 November 2000, 31.

[5]Lester Thurow, *The Future of Capitalism: How Today's Economic Forces Shape Tomorrow's World* (New York: William Morrow and Company, Inc., 1996), 17. George Jochnowitz, "Marx, Money, and Mysticism after Mao," *Partisan Review* 69, no. 1; Paul Hollander, "Which God has Failed?" *The New Criterion Online* 20, no. 6 (February 2002).

ernment intervention.[6] Here in the United States, capitalism appears to be working better than ever before: Poverty in 1998, for example, was at a 33-year low; for minorities, this was its lowest level since records were started.[7]

The passage of time has revealed the truth about some issues fiercely debated just a few decades ago. These include whether economic liberties must be protected to secure civil liberties and whether prosperity is possible without private property rights and markets. The spread of free enterprise to formerly socialist and communist countries allows side-by-side comparisons impossible a few decades ago.

## THE RISE OF EXCHANGE

"Since capitalism was named by its enemies," wrote economist Thomas Sowell, "it is perhaps not surprising that the name is completely misleading. Despite the name, capitalism is not an 'ism.' It is not a philosophy but an economy. Ultimately it is nothing more and nothing less than an economy not run by political authorities."[8]

A standard dictionary defines an economy as "a system of producing, distributing, and consuming wealth." The oldest and most familiar economy is the one that operates within an individual household. The parents typically produce wealth and decide how it will be distributed. Opportunities for production and evidence of individual wants are gathered by observation and dialogue; decisions are made by the assertion of the parents' natural authority over their children.

The economy of the household is separated from other larger economies by specialization and the division of labor.[9] People

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[6]Gerald P. O'Driscoll Jr., Jim R. Holmes, and Melanie Kirkpatrick, *2001 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2001).

[7]Kat N. Grossman, "Poverty Rate at 33-Year Low," *Chicago Sun-Times,* 27 September 2000, 36.

[8]Thomas Sowell, *The Vision of the Anointed* (New York: Basic Books, 1995), 207.

[9]Roger Weiss, *The Economic System* (New York: Random House, 1969), 12–13.

specialize in doing a single thing or a small number of things well because it increases their productivity. By concentrating on developing skills and acquiring (perhaps inventing) the tools needed to perform a small number of tasks extremely well, the specialist can produce more output valuable to others than the person who does not specialize. That output can be exchanged for other goods valued, but not produced, by the specialist.

Specialization leads to the division of labor: People acquire different skills that enable them to work in groups to produce a relatively narrow range of goods in abundance. The potter hires an assistant and becomes a small business, then expands into a factory. Others follow the potter's example, and eventually a pottery industry emerges. Others specialize in making other products, and soon most goods are no longer produced in the same household in which they are consumed. Goods can now be exchanged on a regular basis, increasingly with people who are not members of the producer's household, clan, community, or nation.

## THE COORDINATION PROBLEM

The rise of exchange creates the problem of coordination. How does each group of producers know what to produce or how much of it to produce? It is no longer possible, as it was in the household economy, to simply observe opportunities or ask family members about their wants. When opportunities and customers might be located in different clans, communities, or even nations, who sets the rate at which the goods produced by one group are to be exchanged with goods from another group?

Historically, civilizations have followed three paths to solve the problem of coordination. The first is to rely on tradition. This method extends the natural authority model of the household to the entire clan, community, or nation. The authority to coordinate production, distribution, and consumption is given to an individual or group of individuals by virtue of their birth into a caste or ascension in a tradition-defined hierarchy.

So long as technological change is slow or absent and new production opportunities and consumption wants emerge only slowly, it is possible to rely on tradition to solve the coordination problem even though force or the threat of force must be used to impose unpopular decisions on those insufficiently privileged to participate in the decision-making process. The system excludes from consideration information known by those who lack high status, and therefore it cannot act in response to their knowledge of particular circumstances in time and space. The system thus discourages the innovation and change needed to create new technologies and improve productivity.

A second solution to the coordination problem is the autocratic or militaristic system. This was the model pursued by most nations of the world for most of history, from ancient Sparta until the eighteenth century in most of Europe and into the twentieth century in the former Soviet Union. It is still practiced in parts of Africa and Asia.

Under the autocratic system, a central authority sets production targets and goals, determines how economic resources are distributed among the producing entities, and ultimately decides how much each citizen consumes. The collapse of the Soviet Union and the poverty of countries that still attempt to follow the communist model, such as Cuba and North Korea, are largely attributable to the inability of the central authority to solve the coordination problem.[10] Politically, communism has proven incompatible with democracy.

A third solution is freedom, or the capitalist economy, where there is no conscious authority in charge of operating or managing the economy. Instead, authority is diffused throughout the system. Three institutions are critical to a capitalist economy:

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[10]An authoritative account of how the Soviet Union attempted to direct resource use is John N. Hazard, *The Soviet System of Government* (Chicago: University of Chicago Press, many editions). For a succinct analysis of the failure of centralized control in the Soviet Union, see Richard Pipes, *Property and Freedom* (New York: Random House, 1999), 211–17. A stimulating collection of essays from a variety of disciplines reacting to the worldwide collapse of communism is Mancur Olson and Satu Kahkonen, eds., *A Not-So-Dismal Science: A Broader View of Economies and Societies* (Oxford: Oxford University Press, 2000).

- *Private property.* Property is a person's life and liberty as well as his physical possessions.[11] Private ownership of property means people have rights to the fruit of their labor and whatever other property they acquire through legal means. Alienable property—possessions—can be sold or leased to others for their use. Inalienable property—life and liberty—cannot be sold at any price.
- *Markets.* Markets, from the Latin word *mercatus,* meaning trade, are where trading occurs. Producers (sellers) and consumers (buyers) meet in markets to negotiate mutually agreeable prices for the goods and services that are exchanged. In a free market, no outside authority determines or fixes those prices. Because both buyers and sellers engage in trade voluntarily, both expect to benefit from the exchange, and indeed, both do. An object worth relatively little to one person may be worth more to another because wants, opportunities, and perspectives vary from person to person. The stage is set for a mutually beneficial, voluntary, and free trade.
- *Rule of Law.* The rules defining property rights and the duties and rights of citizens are established, made widely known, and enforced by a system of courts and legislatures. The key aspect of the legal system we have inherited from the ancient Greeks is "equality of laws to all manner of persons," or what we now call the Rule of Law.[12] Because transactions in a capitalist system often take the form of a contract to perform a duty or deliver a product at a later date, capitalism is especially dependent on the Rule of Law to prohibit coercion and fraud, which otherwise would constitute alternatives to voluntary cooperation.

[11]". . . their Lives, Liberties and Estates, which I call by the general Name, *Property.*" [emphasis in original] John Locke, *Two Treatises of Government* (1698; reprint, New York: New American Library, 1963), 395.

[12]Friedrich Hayek, *The Constitution of Liberty* (Chicago: Henry Regnery Co., 1960), 164.

Working together, these three institutions—private property, markets, and the Rule of Law—not only solve the coordination problem but also create the conditions necessary for vast increases in the amount of trade that can take place among individuals and consequently in the amount of specialization and division of labor that can occur. Because it is the division of labor that fuels improvements in productivity, a capitalist system is also an engine for economic growth and prosperity.

## HOW CAPITALISM WORKS

When buyers and sellers meet in a market to exchange goods and services, their offers and bids create prices that can be posted, advertised, and otherwise made known. This feature distinguishes capitalist economies from other economic systems.[13] Prices act as signals telling producers what consumers are willing to buy and consumers what producers are willing to sell. Economist Henry Hazlitt explained, "It is only the much vilified price system that solves the enormously complicated problem of deciding precisely how much of tens of thousands of different commodities and services should be produced in relation to each other. These otherwise bewildering equations are solved quasi-automatically by the system of prices, profits and costs. They are solved by this system incomparably better than any group of bureaucrats could solve them."[14]

Buying and selling is possible only if the parties on each side of a transaction are confident the other will deliver the goods or money agreed on. Paradoxically, a system where everyone is committed to pursuing only his or her own gain places a high premium on voluntary cooperation and promise keeping.[15] Property rights

[13]Friedrich A. Hayek, "The Use of Knowledge in Society," in *Individualism and Economic Order* (1948; reprint, Chicago: Henry Regnery Company, 1972), 77–91.

[14]Henry Hazlitt, *Economics in One Lesson* (1979; reprint, San Francisco: Laissez Faire Books, 1996), 92.

[15]This is a major theme of Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995).

are worthless if they are not respected by others or if one's trading partners resort to violence to change agreements after they have been struck.

Private ownership of property includes the right of individuals to own assets, such as tools, natural resources, land, and in some cases information for their enjoyment or as a means of production. Private ownership means the same person who controls the use of an asset stands to profit when it is used to produce things for which others are willing to pay. The more valuable their products (individually or by their combined volume), the more profit owners can make. Similarly, the owner loses money if the property is put to use poorly or left idle. This creates incentives to put assets to their most productive use.

In a capitalist system, assets such as land can be bought and sold freely. Those who think they can put a particular piece of property to better use than its current owner can bid to own it. The owner of the under-performing property has an incentive to sell it to the highest bidder who is able to pay more than what the property is worth to its current owner. The result is that property tends to find its way into the hands of those who can put it to its best and highest use, thereby minimizing waste and reducing costs.

Entrepreneurs are the agents who are alert to opportunities to make profits by putting resources to better use.[16] Part of the entrepreneurial activity is anticipating what consumers want, how much they are willing to pay for it, and how much it will cost in the future to provide it. Much of the information needed to make accurate forecasts is not available to any one person (even government) at the time decisions must be made.[17] Because entrepreneurs have the most to gain if they decide correctly and the most to lose if they make mistakes, they have every incentive to collect data and choose correctly.

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[16] Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973).

[17] Friedrich A. Hayek, "The Use of Knowledge in Society," in *Individualism and Economic Order* (1948; reprint, Chicago: Henry Regnery Co., 1972), 77–91.

Both entrepreneurs who choose correctly and businesses that produce products most efficiently are able to sell the most product. Those entrepreneurs who consistently guess wrong and businesses that are inefficient producers will sell less and may possibly stop producing products altogether. As a result of this competition, those businesses that remain in the market are the ones that most accurately anticipate and most efficiently meet consumer wants, and the prices they charge tend to be the average or typical market price.

Profits are necessary to the entrepreneurial process. The prospect of profits determines how much a business invests in producing a product. At any given time, there are countless opportunities being created and disappearing in a large and complex economy. The profit motive harnesses the knowledge and self-interest of countless producers and potential producers of goods and services to determine which opportunities should be acted on and which passed over.

Efforts to prioritize production opportunities through central planning or nonprofit institutions fail to tap the knowledge, creativity, and motivation of entrepreneurs and consequently result in inefficiency, waste, and often corruption.[18] An impressive example of the positive effects of profits was the first permanent settlement in America, the Jamestown, Virginia, colony established in 1607. The original settlers, employees of the Virginia Company, did not have a personal financial stake in the success or failure of the colony. For ten years, the colony suffered extreme hardship. Disease and famine claimed the lives of most of the early settlers. "Not until these men became tenant farmers and landowners did Jamestown secure its destiny. As employees, the colonists accomplished nothing; as entrepreneurs, motivated by the opportunity for profit, they built a prosperous, strong community."[19]

Competition among producers (sellers) and consumers (buyers) ensures that the profits earned by entrepreneurs and the

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[18]Stephen C. Littlechild, *The Fallacy of the Mixed Economy* (San Francisco: Cato Institute, 1979), 23.

[19]S. Jay Levy and David A. Levy, *Profits and the Future of American Society* (New York: The New American Library, Inc. 1983), 4.

prices paid by consumers tend to be driven down toward the lowest level a producer is able to accept and still have enough money to produce the product.[20] If one producer tries to keep his prices too much higher than his cost of production, the profit motive causes other producers to try taking orders away by offering a lower price. In this way, competition and choice ensure that better goods and services are available at lower cost to consumers who most value them.

Competition leads employers to pay their employees wages equal to the marginal productivity of workers, which is what consumers would willingly pay for their output.[21] (A marginal change is a very small increment or decrement to the total quantity of some variable. In economics, it often refers to the last or final increment or decrement in quantity, where it may be more or less than the average value of the variable. Decisions are often made on the basis of the marginal cost or benefit of the outcome.)

Employers compete for employees by offering the best combination of pay, conditions, and opportunities for advancement, but no employer can afford (for long) to pay more than the value added by the employee's contribution to the firm's workforce. If employers pay less than the value an employee creates, the employee is in a good position to negotiate a raise or seek employment with a competitor. If an employee were paid more than the value he or she added, the search for profits would cause the employer to reduce pay or find another employee able to do the same job for less. The amount of compensation employees get in exchange for their labor, then, tends to be the value of what they contribute to production.

Interest is a third source of income (in addition to wages and profits) in a capitalist economy. Interest is earned on money lent

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[20]A more detailed, and technically accurate, description of how prices are determined appears in Chapter 5.

[21]In economese: Wages in equilibrium equal "the rates at which the utility of consumers would trade against the utility of workers on the margin at which all gains from trade have been exploited." Don Ballante, "Labor Economics," in *The Elgar Companion to Austrian Economics,* ed. Peter J. Boettke (Cheltenham, UK: Edward Elgar Publishing, Inc., 1994), 260.

to others, either in a direct transaction or indirectly by deposit into bank accounts or investment in bonds. Interest rates are controlled by the interaction of supply and demand so as to reflect the price consumers would willingly pay to have money now rather than later. Different investment opportunities—equities, bonds, and other vehicles—compete for investors' dollars by offering different levels of risk and returns. If interest rates are set too high, businesses and consumers borrow less and save more, resulting in less demand for loans and a greater supply of money to lend. Interest rates are therefore forced downward.

Interest rewards those who defer consumption, thereby making possible the production of capital goods, such as machines or schools (schools create human capital). These increase the productivity of other factors of production, such as labor and land, making rising income and greater prosperity possible. The rate of interest rations or meters investments into those forms of capital most valuable to consumers.

Although the roles of investor and entrepreneur are sometimes combined, it is more useful to consider them different functions. The entrepreneurial task does not require an investment of resources but only an alertness to opportunities for such investments to be made. Investment may (or may not) follow an entrepreneur's discovery, depending on the riskiness and likely rate of return of competing opportunities. Risky innovations require both visionary entrepreneurs and courageous investors.

## ORIGINS IN ENGLAND

Where did capitalism come from, and what can we learn from its history? Prior to the eighteenth century, few economies in the world had all three capitalist institutions at once or for long periods of time.[22] Typically, foreign invaders or homegrown despots

[22]Richard Pipes describes instances where cities or provinces flourished for periods ranging from a few years to several decades, but eventually succumbed (usually by military conquest) to autocratic rule. Pipes, *Property and Freedom,* 107–11, 169–72. (In note 10 above.)

undermined capitalist institutions by confiscating property, fixing prices, or failing to enforce or honor voluntary contracts.

According to historian Richard Pipes, "the earliest articulation in intellectual history of the theory that liberty is 'inalienable' property, thereby laying the foundation of the concept of inalienable rights," appeared in 1625 in Hugo Grotius's *On the Law of War and Peace.*[23] This idea—the keystone of the abolitionist movement, the civil rights movement, and our contemporary notions of individual freedom and the right to privacy—first occurred in a discussion of various categories of property.

"The prevalent view among the English people in the early seventeenth century," Pipes continues, "held property to be the essence of liberty: 'To say that something was a man's property . . . was precisely to say that the thing in question could not be taken away from him without his consent. To take property without consent was to steal, and thus to break the Eighth Commandment.' From which it followed that the king could not tax his subjects or otherwise diminish their assets except with their consent given through their representatives."[24]

The English perspective on property rights was famously expressed by John Locke in *Two Treatises on Civil Government,* published in 1690. In Chapter 5 of the Second Treatise, he contends the right to private property precedes the creation of governments: "But I shall endeavor to show, how Men might come to have a *property* in several parts of that which God gave to Mankind in common, and that without any express Compact of all the Commoners."[25]

The right to property, Locke explained, is inseparable from individual freedom:

[23]Ibid., 28–31.

[24]Ibid., 137, quoting J. P. Sommerville, *Politics and Ideology in England, 1603–1640,* 147.

[25]John Locke, *Two Treatises on Government,* 2d ed., ed. Peter Laslett, Second Treatise (Cambridge Mass.: Cambridge University Press, 1967), 327.

> Though the Earth, and all inferior Creatures be common to all Men, yet every Man has a Property in his own Person. This no Body has any Right to but himself. The Labour of his Body, and the Work of his Hands, we may say, are properly his. Whatsoever then he removes out of the State that Nature hath provided, and left it in, he hath mixed his Labour with, and joined to it something that is his own, and thereby makes it his Property. It being by him removed from the common state Nature placed it in, hath by this labour something annexed to it, that excludes the common right of other Men. For this Labour being the unquestionable Property of the Labourer, no Man but he can have a right to what that is once joined to, at least where there is enough, and as good left in common for others.[26]

The purpose of government, Locke concluded, is to protect the property rights of its citizens, "For the preservation of Property being the end of Government, and that for which Men enter into Society, it necessarily supposes and requires, that the People should have Property, without which they must be supposed to lose that by entering into Society, which was the end for which they entered into it, too gross an absurdity for any Man to own."[27]

Locke's reasoning, echoed by other writers and political activists of the time, laid the foundation for the most important words in the U.S. Declaration of Independence—"that all men are created equal, that they are endowed by their Creator with certain unalienable rights, that among these are Life, Liberty, and the Pursuit of Happiness." And Locke's reasoning is enshrined in the Fifth Amendment of the U.S. Constitution, which provides that "no person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use without just compensation."

The discovery that private property, markets, and the Rule of Law together create an economy that works best without government management is generally attributed to Adam Smith

[26]Ibid., 328–29.

[27]Ibid., 406.

(1723–1790).[28] In *The Wealth of Nations,* published in 1776, Smith described how "every individual . . . intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an *invisible hand* to promote an end which was no part of his intention."[29]

We now know how Adam Smith's invisible hand operates. The promise of profits steers investments to activities that produce the biggest returns by meeting consumers' most urgent and unfilled wants. Self-interest guides consumers to the most efficient producers (who can offer the best value for money), and competition among producers ensures that innovation and efficiency are rewarded. Contracts capture the terms of transactions that may be very complex, involve many participants, extend over long periods of time, and take into account changing circumstances.

Such a system, while constantly churning and changing, nevertheless works as an efficient and voluntary solution to the coordination problem. Whenever something gets out of order—a shortage of one good here, an excess of some other product there—the price system signals self-interested people to devote their energies to fixing the problem. Resources that are valuable to society rarely stay for long with those unable or unwilling to put them to use.

The capitalist system squeezes out waste by efficiently communicating wants and opportunities across huge distances and cultural differences. It accommodates the highly variable objectives of participants and rewards innovation. There is no need to oversell these aspects of capitalism. They are tendencies that work over time, not instant adjustments to every situation.

[28]Adam Smith, *The Wealth of Nations* (1776; reprint, Chicago: University of Chicago Press, 1976), 477–78. Smith brought together and popularized ideas that were already being written about by others in Scotland and France. See W. L. Taylor, *Francis Hutcheson and David Hume as Predecessors of Adam Smith* (Durham, N.C.: Duke University Press, 1965).

[29]Adam Smith, *Wealth of Nations,* book 4, chap. 2. Emphasis added.

Circumstances in the real world slow or mitigate the market's response to a problem or an opportunity, but history compellingly demonstrates that, although capitalism is imperfect, no other system is better.

The beliefs of Locke and the Founding Fathers of the United States are generally labeled classical liberalism. This, unfortunately, is easily confused with modern liberalism, which advocates the use of government power to improve the human condition, nearly the opposite of what the Founders advocated. The label traded hands early in the twentieth century. Contemporary classical liberals sometimes label themselves libertarians to avoid confusion.[30]

The libertarian ideas of private property rights, individual freedom, and limited government gave birth to innovation, exchange, and the creation of wealth. Capitalism set England and America on the path of economic growth that would allow them to become beacons of freedom and prosperity for the rest of the world. George Stigler puts it clearly: "The immense proliferation of general education, of scientific progress, and of democracy are all coincidental in time and place with the emergence of the free enterprise system of organising the marketplace. I believe this coincidence was not accidental. The economic progress of the past three centuries was both cause and effect of this general growth of freedom."[31]

## THE FOUNDERS' VALUES TODAY

Do the values that led to the adoption of capitalism's institutions and the founding of the United States still resonate with Americans today? Seymour Martin Lipset recently reviewed many international surveys of values and found that classical liberal, or libertarian, ideals are still at the core of mainstream

[30]See David Boaz, *Libertarianism: A Primer* (New York: The Free Press, 1997) and an edited collection by the same author, *The Libertarian Reader* (New York: The Free Press, 1997).

[31]George J. Stigler, "The Intellectual and the Market Place," Occasional Paper #1 (UK, Institute for Economic Affairs, 1963), 15.

American values. He concludes, "The American Creed can be described in five terms: liberty, egalitarianism, individualism, populism, and laissez-faire. Egalitarianism, in its American meaning, as Tocqueville emphasized, involves equality of opportunity and respect, not of result or condition."[32]

Lipset cites national surveys that show 66 percent of U.S. adults agreed that the "Government is almost always wasteful and inefficient." A similar percentage agreed that "most elected officials don't care what people like me think." The percentage of adults agreeing that "government is pretty much run by a few big interests looking out for themselves rather than for the benefit of all the people" rose from 29 percent in 1964 to 80 percent in 1992.[33]

Such cynicism appears justified. According to Lipset, "The number of officials indicted on charges of public corruption increased by a staggering 1,211 percent" from 1975 through 1989.[34] When asked how much confidence they have in banks, big business, Congress, the criminal justice system, labor, the medical system, the military, newspapers, the police, and television, those surveyed ranked Congress second to last, before only the criminal justice system.[35]

Compared with citizens in other economically advanced countries, Americans are more hopeful for their own lives and more willing to take personal risks. Lipset found that 81 percent of Americans agreed with the statement, "I am optimistic about my personal future." When asked to choose between security and an opportunity to succeed, 76 percent chose opportunity. Seventy-four percent of adults agreed that, "In America, if you work hard, you can be anything you want to be." Although federal, state, and local governments have grown lustily in the past two centuries,

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[32]Seymour Martin Lipset, *American Exceptionalism* (New York: W. W. Norton, 1996), 19.

[33]Ibid., 282.

[34]Ibid., 286.

[35]Morris P. Fiorina and Paul E. Peterson, *The New American Democracy* (Boston: Allyn & Bacon, 1999), 379.

the United States still leaves a larger share of national income, than do other nations, to individuals to spend as they wish. Americans mistrust centralized authority, desire private over public ownership, and resist taxes for government to redistribute for entitlements and welfare. Morris Fiorina and Paul Peterson point out that "Even the very poorest Americans reject a government-guaranteed income, and only the very poorest feel that the government should reduce income differences. . . . The poor dislike the progressive income tax as much as the rich."[36] Only 23 percent of Americans completely agreed that the government should take care of very poor people who cannot take care of themselves; this is in contrast to 45 to 71 percent of citizens in 14 European countries.

Perhaps none of this should be surprising. The United States was founded on a set of well-articulated ideas. The overwhelming majority of immigrants, who for three centuries voluntarily risked their lives and fortunes to come to the New World, were drawn by those ideas. Having come here to escape political, religious, and social oppression, it is not surprising that they opposed the imposition of the same in their new homeland. Their children, and their children's children, still bear the mark of a revolution in ideas that occurred nearly four centuries ago.

## CAPITALIST VERSUS GOVERNMENT SCHOOLS

We can now compare and contrast capitalism with the way schools are financed and organized in the United States today. The differences are striking. As John F. Witte, a political scientist who is skeptical of education privatization, describes some of the differences, "Nearly every aspect of this system should repulse a true believer in economic markets. Consumers are forced to accept services they might not have purchased on their own. Households are forced to pay for services they might not receive.

[36]Ibid., 119.

Families are given incentives to produce children they may not want. Producers are constrained in the products they offer. The whole system is guided neither by efficiency nor equity. The democratic impulse of school board members to win reelection, and administrators and teachers to retain their jobs and increase their salaries through collective and political actions, are not linked to the products they produce—children's education."[37] Witte's overview is generally correct, although few if any proponents of privatization believe the current system of school finance leads parents to produce children they may not want.

In a capitalist economy, profits are the reward earned by firms that maximize the quality of services and goods, minimize overhead and bureaucracy, motivate their workers to achieve high and consistent levels of productivity, and avoid unnecessary expenditures. Successful firms generally sell better, cheaper, or better *and* cheaper products and services than do other firms. Customers notice, and business gradually shifts from inefficient to efficient firms. Everyone benefits from this shift: Consumers get better products and lower prices that suit their choices; workers get paid more for their work; and entrepreneurs and investors earn larger profits and higher rates of return, which enable them to invent and invest in even better technologies, thus completing a virtuous circle beneficial to all. Even the failure of unproductive firms shows the power of markets to eliminate waste and inefficiency.

The current system of government schooling is dramatically different. Schools can raise spending and reduce the quality of their service without fear of losing customers because they compete only in highly attenuated ways for students or funding. Only when conditions become frightfully bad—when schools cannot even protect the physical well-being of students—do significant numbers of parents make the sacrifice of buying new homes in school districts with better government schools or of paying private school tuition in addition to school taxes. For the well-to-do, these choices may not be difficult to make; for the poor, they are often impossible.

[37]John F. Witte, *The Market Approach to Education* (Princeton: Princeton University Press, 2000), 201.

The absence of voluntarily paid tuition means there are no prices to guide the decisions of either government school managers or parents (consumers). The system fails, for example, to reveal how much parents are willing to spend on their children's education. School taxes are spread across the federal, state, and local levels of government, and even at the local level, they are part of a property tax bill that is difficult for most taxpayers to decipher. Local school board elections rarely offer candidates with explicit views on how much they believe should be spent. Once elected, moreover, candidates may not achieve what they promised during their campaigns.

Whereas managers of commercial enterprises measure profits at the end of a month or a quarter to determine how competitive their products are, government-school superintendents can only guess why their enrollments fluctuate from year to year. This lack of feedback from willing customers must severely handicap even the most dedicated school administrators, principals, and teachers. While their private-sector counterparts study competitors to benchmark their own performance, government school superintendents work as if in a darkened room, trying to interpret shadows on the wall cast by anecdotes or reports from other, similarly handicapped, school districts.

Teachers and administrators in low-performing government schools are unlikely to be paid any less than teachers and administrators in high-performing schools, which discourages increased effort and kills momentum for change. Teachers union contracts are likely to forbid merit pay, further discouraging added effort. Unlike entrepreneurs in the private sector, government school superintendents are likely to be paid based on the size of their bureaucracies and not according to the quality and efficiency of the output of their enterprises.

Low-performing government schools don't gradually lose customers and face the threat of closure, the way an inefficiently run business does. As a result, there is little urgency for reform. Their assets do not move from the control of those who have misused them into the hands of others who could do a better job. Instead, an elaborate blame game is played whereby elected school board members blame taxpayers for not providing sufficient funding, administrators blame school board members for meddling and parents for failing to prepare their children to learn, and teachers blame administrators for failing to back them up or give them greater flexibility in the classroom. State-funding formulas are more likely to reward than punish schools that consistently report low test scores, which creates perverse incentives for the staffs of failing schools.

## CONCLUSION

Capitalism, as Thomas Sowell said in *The Vision of the Anointed,* is not an ideology. It is "an economy not run by political authorities."[38] Instead of elections, laws, and bureaucracy, capitalism relies on markets, private property, and the Rule of Law. Instead of deliberate planning, it relies on prices, competition, and profits to direct resources to where they are most needed and to reward those who can best satisfy the wants of others.

Capitalism did not just happen. Its emergence over the course of several centuries is inseparable from the rise of equality, individual liberty, and other key elements of the American Creed. Its unique ability to solve the coordination problem—to tell increasingly specialized producers what products to produce and in what quantities—has unleashed spectacular increases in production and wealth, leading to the advances in products and services we now take for granted.

At first blush, it seems plausible that moving schooling from the public sector to the private sector would solve some of the most serious problems facing government schools today. By introducing competition, prices, and profits, privatization would replace ineffectual school boards, reduce the power of teachers unions, end conflicts of interest, and create new incentives for higher performance.

[38] Sowell, *Vision of the Anointed.*

Our analysis at this stage is incomplete, but one thing is already clear: The economic order that brings food to our tables, puts roofs over our heads, and provides for so many of our other basic needs also holds valuable lessons for our nation's faltering government schools. Surely this avenue for reform is worthy of further study.

## RECOMMENDED READING

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