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# What Is Capitalism?

Capitalism is an economic system in which private individuals or businesses own capital goods. At the same time, business owners employ workers who receive only wages; labor doesn't own the means of production but instead uses them on behalf of the owners of capital.

The production of goods and services under capitalism is based on supply and demand in the general market, also known as the market economy. This is in contrast to a planned economy or a command economy, in which prices are set through central planning.

The purest form of capitalism is free-market or laissez-faire capitalism. Here, private individuals are unrestrained. They may determine where to invest, what to produce or sell, and at which prices to exchange goods and services. The laissez-faire marketplace operates without checks or controls. Today, most countries practice a mixed capitalist system that includes some degree of government regulation of business and some extent of public ownership of select industries.

## Understanding Capitalism

Capitalism is one type of system of economic production and resource distribution. Instead of planning economic decisions through centralized political methods, as with socialism or feudalism, economic planning under capitalism occurs via decentralized, competitive, and voluntary decisions.

Capitalism is essentially an economic system in which the means of production—factories, tools, machines, raw materials, etc—are organized by one or more business owners, also known as capitalists. Capitalists then hire workers to operate the means of production in return for wages. Workers have no claim on the means of production or on the profits generated from their labor; these belong to the capitalists.

As such, private property rights are fundamental to capitalism. Most modern concepts of private property stem from John Locke's theory of homesteading, in which human beings claim ownership by mixing their labor with unclaimed resources. Once owned, the only legitimate means of transferring property are through voluntary exchange, gifts, inheritance, or the re-homesteading of abandoned property.

Private property promotes efficiency by giving the owner of resources an incentive to maximize the value of their property. The more valuable a resource is, the more trading power it provides the owner. In a capitalist system, the person who owns the property is entitled to any value associated with that property.

# Why Private Property Rights Matter for Capitalism

For individuals or businesses to deploy their capital goods confidently, a system must exist that protects their legal right to own or transfer private property. A capitalist society relies on the use of contracts, fair dealing, and tort law to facilitate and enforce these private property rights.

When property isn't privately owned but rather is shared by the public, a problem known as the tragedy of the commons can emerge. With a common pool resource—which all people can use and none can limit access to—all individuals have an incentive to extract as much use-value as they can and no incentive to conserve or reinvest in the resource. Privatizing the resource is one possible solution to this problem, along with various voluntary or involuntary collective action approaches.

# Capitalism and the Profit Motive

Profits are closely associated with the concept of private property. By definition, an individual only enters into a voluntary exchange of private property when they believe the exchange benefits them in some psychic or material way. In such trades, each party gains extra subjective value, or profit, from the transaction.

The profit motive, or the desire to earn profits from business activity, is the driving force of capitalism. It creates a competitive environment in which businesses compete to be the low-cost producer of a certain good in order to gain market share. If it is more profitable to produce a different type of good, then a business is incentivized to switch.4

Voluntary trade is another, related mechanism that drives activity in a capitalist system. The owners of resources compete with one another over consumers, who, in turn, compete with other consumers over goods and services. All this activity is built into the price system, which balances supply and demand to coordinate the distribution of resources.

Feudalism and the Roots of Capitalism

Capitalism grew out of European feudalism. Up until the 12th century, a very small percentage of the population of Europe lived in towns. Skilled workers lived in the city but received their keep from feudal lords rather than a real wage, and most workers were serfs for landed nobles. However, by the late Middle Ages, rising urbanism, with cities as centers of industry and trade, became more and more economically important.

Under feudalism, society was segmented into social classes based on birth or family lineage. Lords (nobility) were the landowners, while serfs (peasants and laborers) didn't own land but were under the employ of the landed nobility.

The advent of industrialization revolutionized the trades and encouraged more people to move into towns where they could earn more money working in a factory than existing at a subsistence level in exchange for labor.

# Mercantilism

Mercantilism gradually replaced the feudal economic system in Western Europe and became the primary economic system of commerce during the 16th to 18th centuries. Mercantilism started as trade between towns, but it wasn't necessarily competitive trade. Initially, each town had vastly different products and services that were slowly homogenized over time by demand.6

After the homogenization of goods, trade was carried out in broader and broader circles: town to town, county to county, province to province, and, finally, nation to nation. When too many nations were offering similar goods for trade, the trade took on a competitive edge that was sharpened by strong feelings of nationalism on a continent that was constantly embroiled in wars.

Colonialism flourished alongside mercantilism, but the nations seeding the world with settlements weren't trying to increase trade. Most colonies were set up with an economic system that smacked of feudalism, with their raw goods going back to the motherland and, in the case of the British colonies in North America, being forced to repurchase the finished product with a pseudo-currency that prevented them from trading with other nations.

It was economist Adam Smith who noticed that mercantilism was a regressive system that was creating trade imbalances between nations and keeping them from advancing. His ideas for a free market opened the world to capitalism.7

# The Growth of Industry

Adam Smith's ideas were well-timed, as the Industrial Revolution was starting to cause tremors that would soon shake the Western world. The (often-literal) gold mine of colonialism had brought new wealth and new demand for the products of domestic industries, which drove the expansion and mechanization of production.

As technology leaped ahead and factories no longer had to be built near waterways or windmills to function, industrialists began building in the cities where there were now thousands of people to supply labor.

*Capitalism involved reorganizing society into social classes based not on ownership of land, but ownership of capital (in other words, businesses). Capitalists were able to earn profits from the surplus labor of the working class, who earned only wages. Thus, the two social classes defined by capitalism are the capitalists and the laboring classes.8*

Industrial tycoons were the first people to amass wealth, often outstripping both the landed nobles and many of the money-lending/banking families. For the first time in history, common people could have hopes of becoming wealthy. The new money crowd built more factories that required more labor, while also producing more goods for people to purchase.

During this period, the term "capitalism"—originating from the Latin word "*capitalis*," which means "head of cattle"—rose to prominence. In 1850, French socialist Louis Blanc used the term to signify a system of exclusive ownership of industrial means of production by private individuals rather than shared ownership.9

## Pros and Cons of Capitalism

### Pros

* More efficient allocation of capital resources
* Competition leads to lower consumer prices
* Wages and general standards of living rise overall
* Spurs innovation and invention

### Cons

* Creates inherent class conflict between capital and labor
* Generates enormous wealth disparities and social inequalities
* Can incentivize corruption and crony capitalism in the pursuit of profit
* Produces negative effects such as pollution