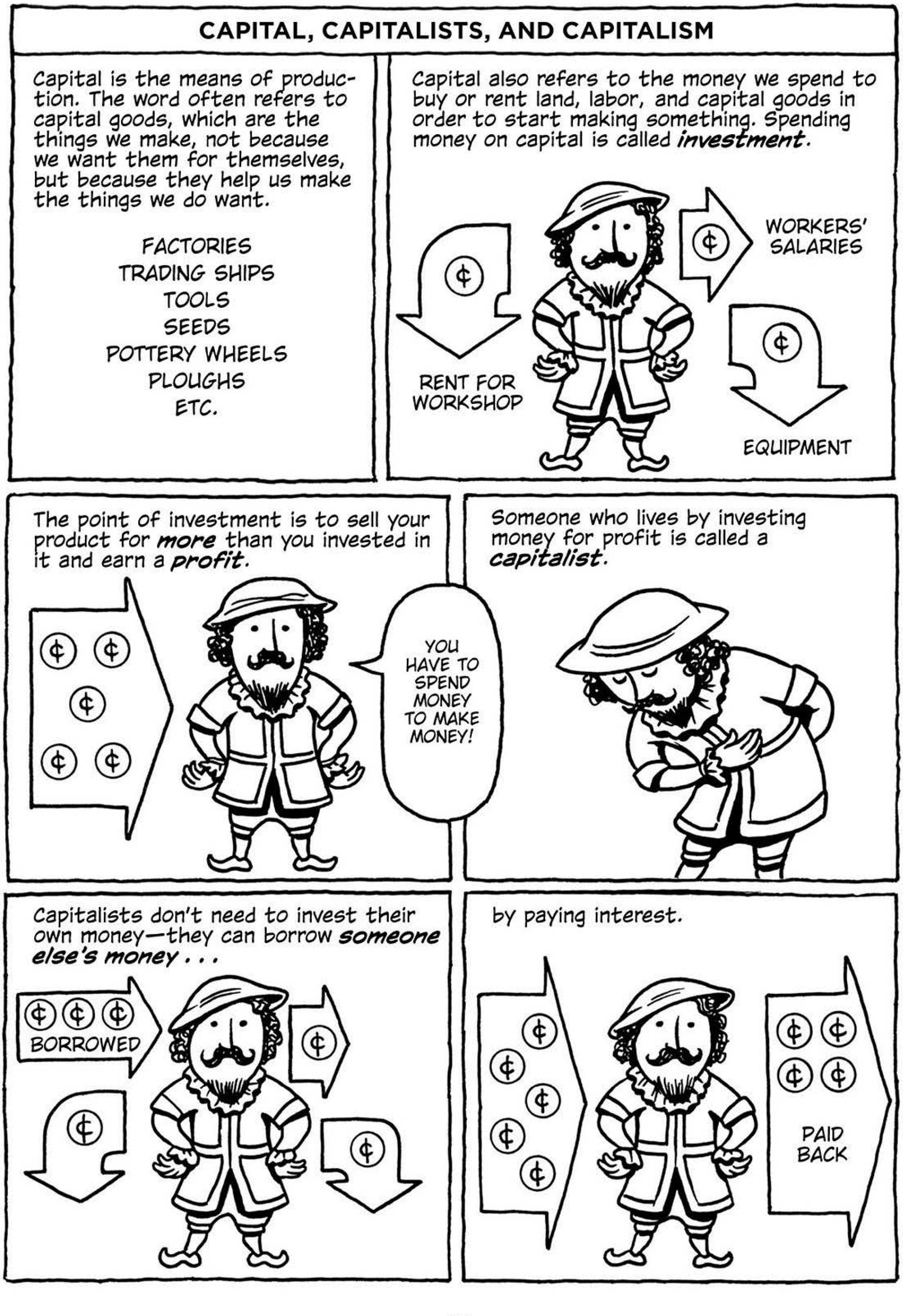
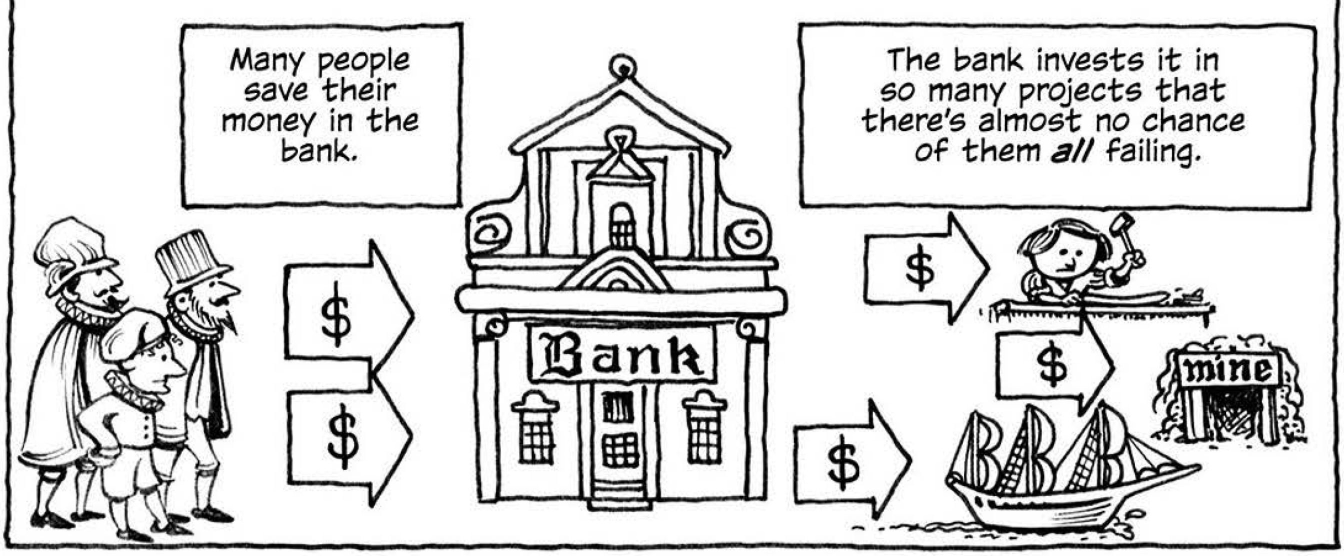

CAPITAL, CAPITALISTS, AND CAPITALISM
Capital is the means of production. The word often refers to capital goods, which are the things we make, not because we want them for themselves, but because they help us make the things we do want.
FACTORIES
TRADING SHIPS
TOOLS
SEEDS
POTTERY WHEELS
PLOUGHS
ETC.
Capital also refers to the money we spend to buy or rent land, labor, and capital goods in order to start making something. Spending money on capital is called *investment*.
¢
RENT FOR WORKSHOP
¢
WORKERS' SALARIES
¢
EQUIPMENT
The point of investment is to sell your product for *more* than you invested in it and earn a *profit*.
¢ ¢ ¢ ¢ ¢
YOU HAVE TO SPEND MONEY TO MAKE MONEY!
Someone who lives by investing money for profit is called a *capitalist*.
Capitalists don't need to invest their own money—they can borrow *someone else's money . . .*
¢ ¢ ¢
BORROWED
¢
¢
¢
by paying interest.
¢ ¢ ¢ ¢ ¢
¢ ¢ ¢ ¢
PAID BACK


So capitalists don't need capital, exactly. What they need is the guts to undertake new projects.
I'M AN *UNDERTAKER!*
HMM. SAY IT IN FRENCH.
I'M AN *ENTREPRENEUR!*
Now: Capitalists have been around for millennia, but the capitalist economy is fairly recent. For most of history, most people lived in farming economies governed by *tradition*.
New projects were often *frowned* on.
NEW THINGUMAWATCHIT!
FOR SALE
Also, investing isn't the same thing as saving. To save, you hold on to your money. To invest, you let it go.
Letting go of your savings is risky. In the farming economies of the past, it was often *very risky*, so people often saved their money *without* investing it.
Capital, capitalists, and things that took a lot of capital to make, such as *metal* goods, were often rare. Which is one reason medieval barbers were also *surgeons*.
WAIT—*WHAT* ARE YOUR QUALIFICATIONS?
MY RAZOR'S THE ONLY SHARP BLADE IN TOWN!
THAT'S *IT*?

Nobody likes risk. Over the centuries, capitalists invented ways to make investing ***less*** risky, like ***banking***.

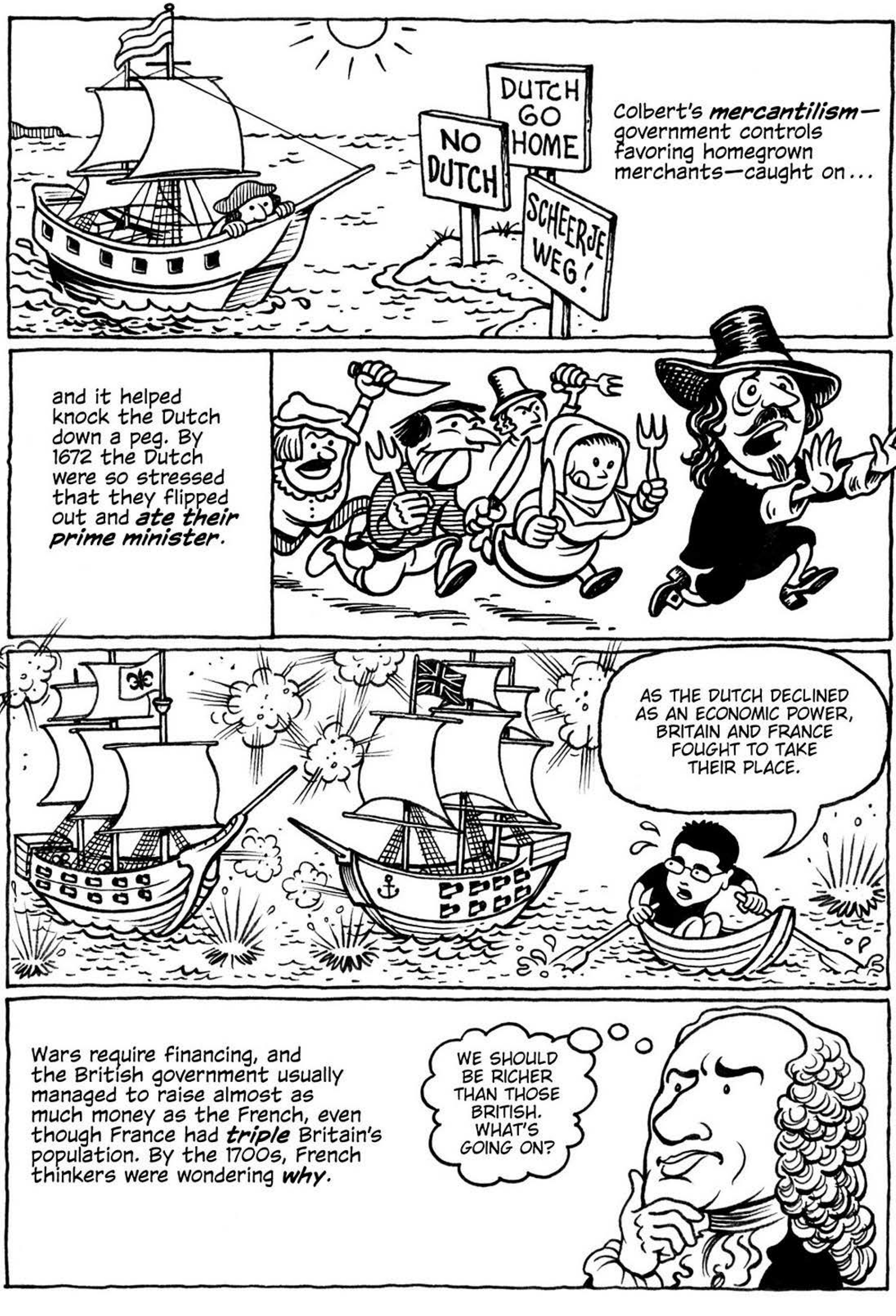


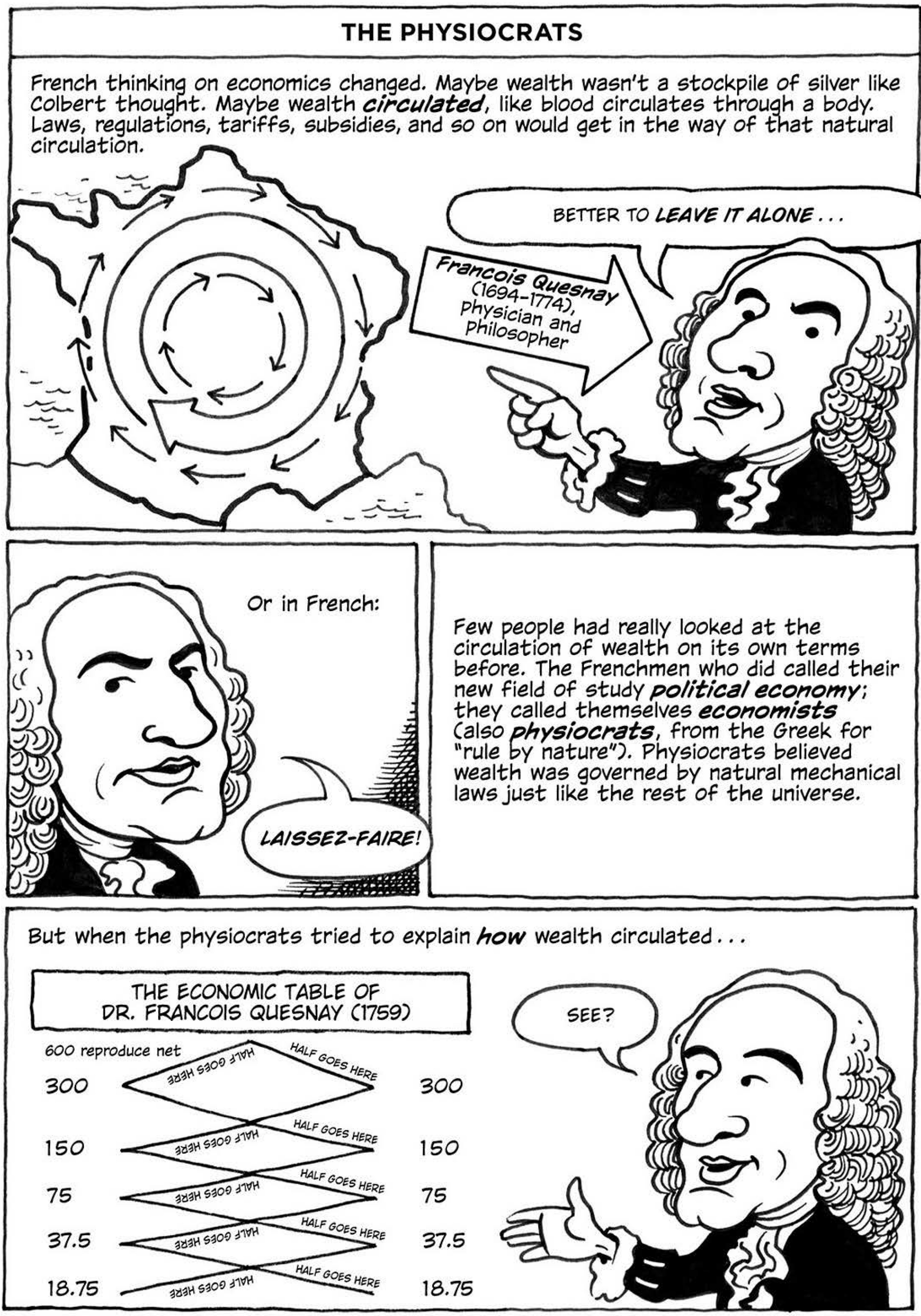
By the 17th century, the ***Dutch*** were making good use of banking, insurance, and other capitalist innovations. They ***organized their economy*** around trade and manufacturing more than around farming.

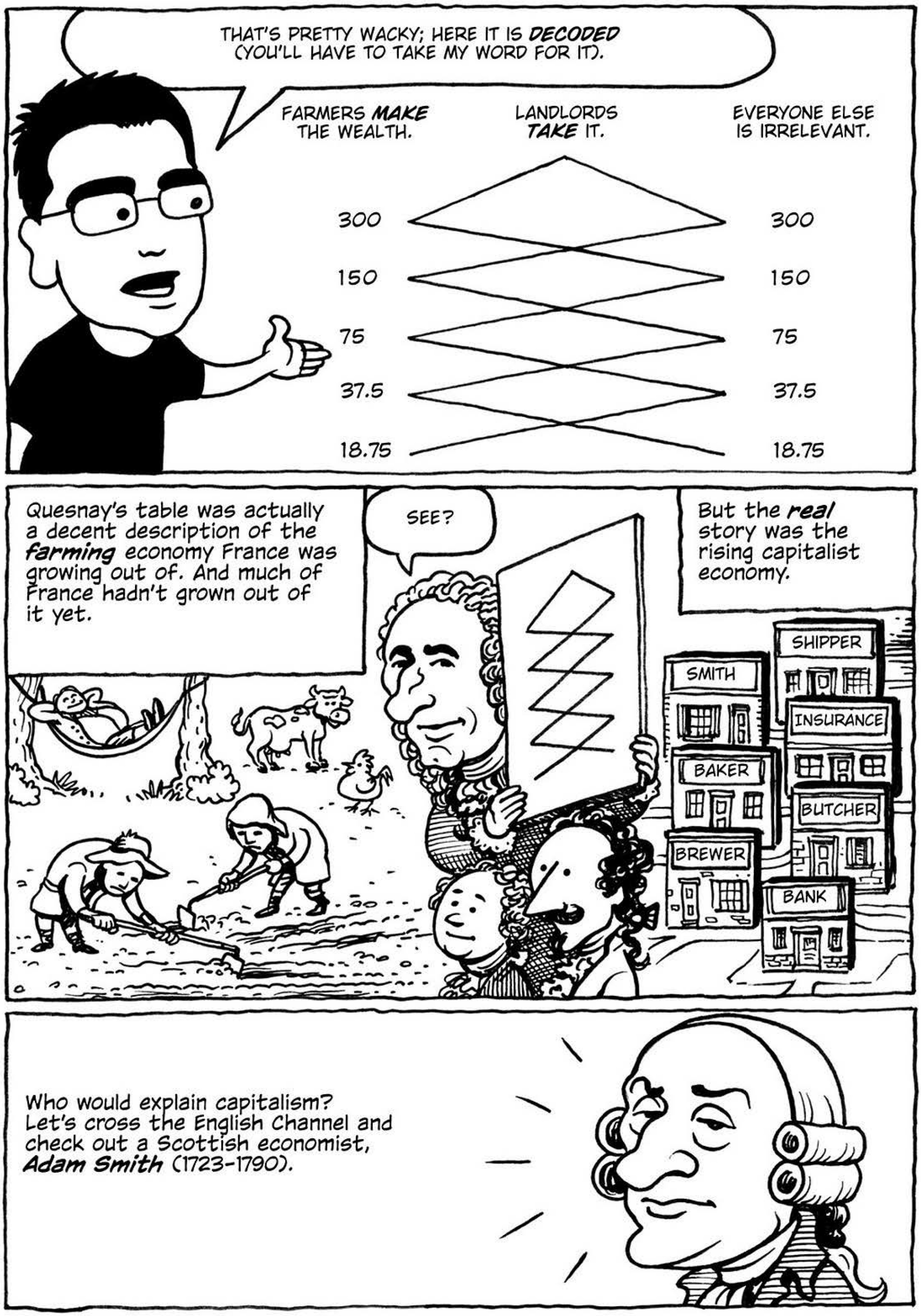
Dutch businesses were so efficient that they ***ruled Europe's trade*** – even people ***at war*** with the Dutch still bought goods from them.

This ***vexed*** some people.

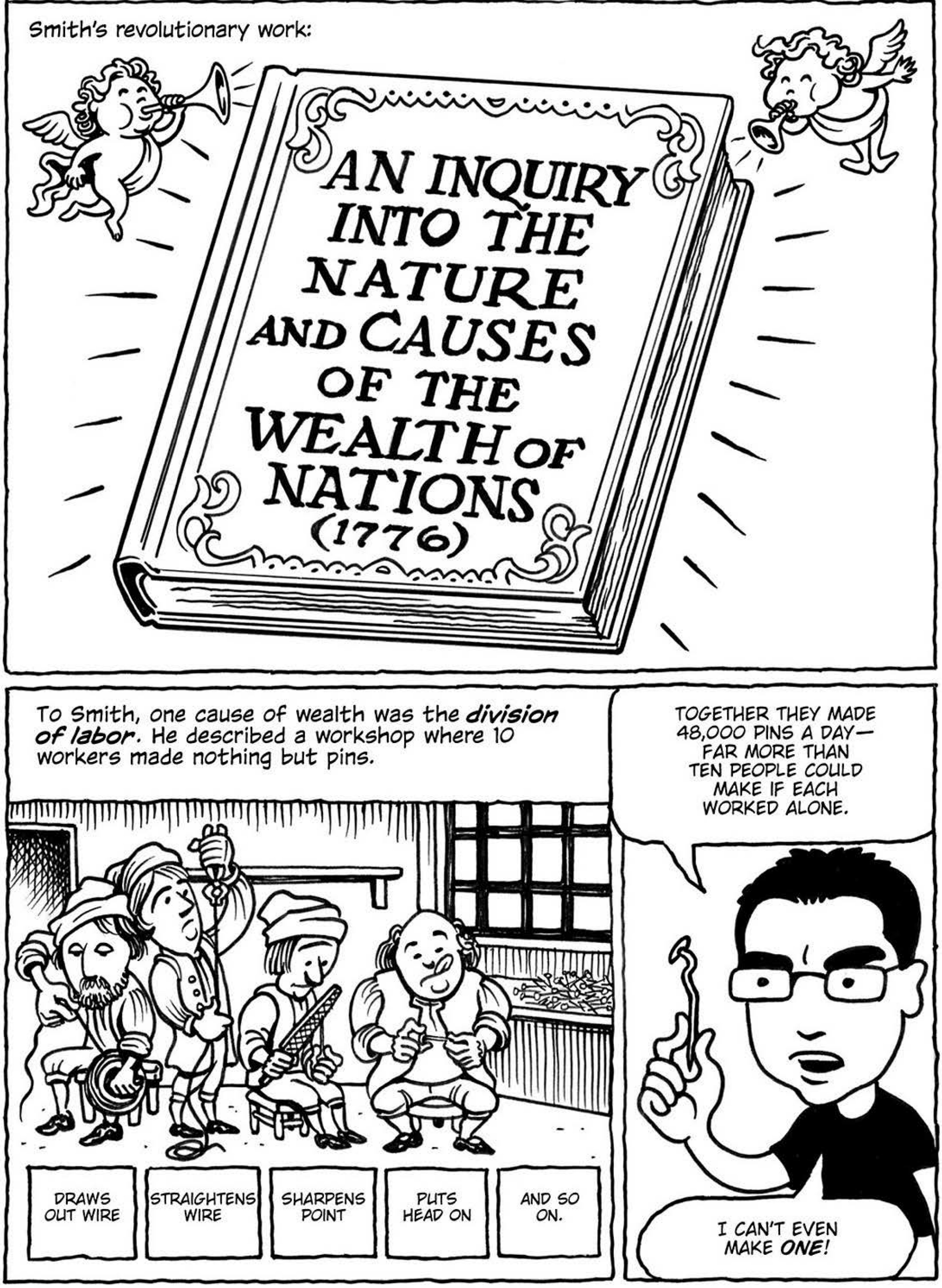

Enter ***Jean-Baptiste Colbert*** (1619-1683), who became finance minister of France in 1665. He thought ***money*** was ***wealth***, end of story.
"EVERYONE . . . AGREES THAT THE MIGHT AND GREATNESS OF A STATE IS MEASURED ENTIRELY BY THE QUANTITY OF SILVER IT POSSESSES."
In this book, direct quotes will be in italics with quotation marks. Otherwise I'm, um, putting words in people's mouths.
Colbert wanted to keep foreign hands off France's money.
ESPECIALLY DUTCH HANDS!
This meant:
SUBSIDIES FOR EXPORTS
TAXES ON IMPORTS (*TARIFFS*)
YOUR FABRIC MUST CONTAIN EXACTLY 1,408 THREADS!
HOW TO WEAVE
REGULATIONS FOR FRENCH BUSINESSES (SO THEIR PRODUCTS WERE GOOD ENOUGH TO COMPETE WITH DUTCH ONES)

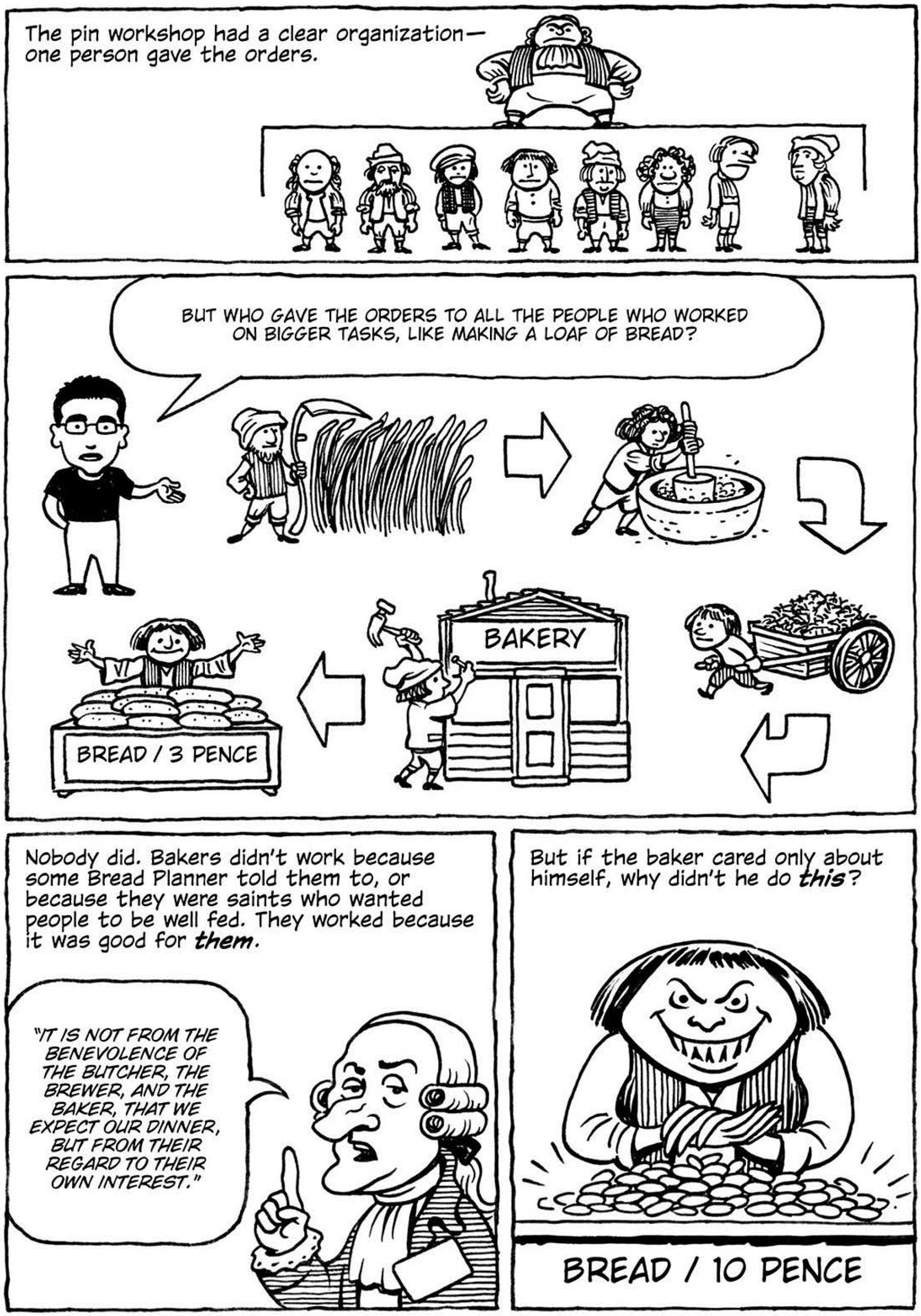

DUTCH GO HOME
NO DUTCH
SCHEERJE WEG!
Colbert's **mercantilism**—government controls favoring homegrown merchants—caught on...
and it helped knock the Dutch down a peg. By 1672 the Dutch were so stressed that they flipped out and ***ate their prime minister***.
AS THE DUTCH DECLINED AS AN ECONOMIC POWER, BRITAIN AND FRANCE FOUGHT TO TAKE THEIR PLACE.
Wars require financing, and the British government usually managed to raise almost as much money as the French, even though France had ***triple*** Britain's population. By the 1700s, French thinkers were wondering ***why***.
WE SHOULD BE RICHER THAN THOSE BRITISH. WHAT'S GOING ON?

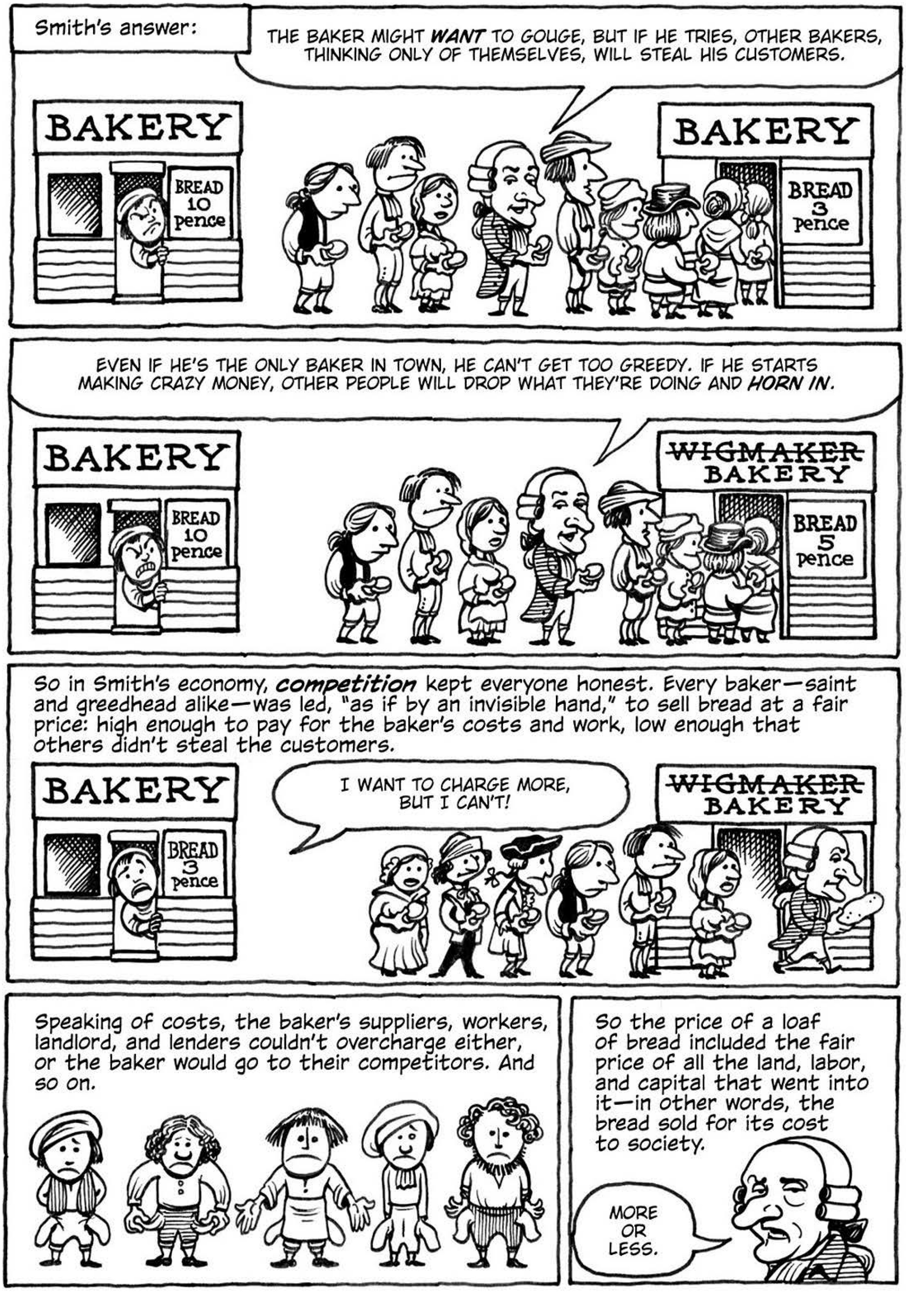

THE PHYSIOCRATS
French thinking on economics changed. Maybe wealth wasn't a stockpile of silver like Colbert thought. Maybe wealth *circulated*, like blood circulates through a body. Laws, regulations, tariffs, subsidies, and so on would get in the way of that natural circulation.
BETTER TO *LEAVE IT ALONE* . . .
Francois Quesnay (1694–1774), physician and philosopher
Or in French:
LAISSEZ-FAIRE!
Few people had really looked at the circulation of wealth on its own terms before. The Frenchmen who did called their new field of study *political economy*; they called themselves *economists* (also *physiocrats*, from the Greek for "rule by nature"). Physiocrats believed wealth was governed by natural mechanical laws just like the rest of the universe.
But when the physiocrats tried to explain *how* wealth circulated . . .
THE ECONOMIC TABLE OF DR. FRANCOIS QUESNAY (1759)
600 reproduce net
300
HALF GOES HERE
HALF GOES HERE
300
150
HALF GOES HERE
HALF GOES HERE
150
75
HALF GOES HERE
HALF GOES HERE
75
37.5
HALF GOES HERE
HALF GOES HERE
37.5
18.75
HALF GOES HERE
HALF GOES HERE
18.75
SEE?

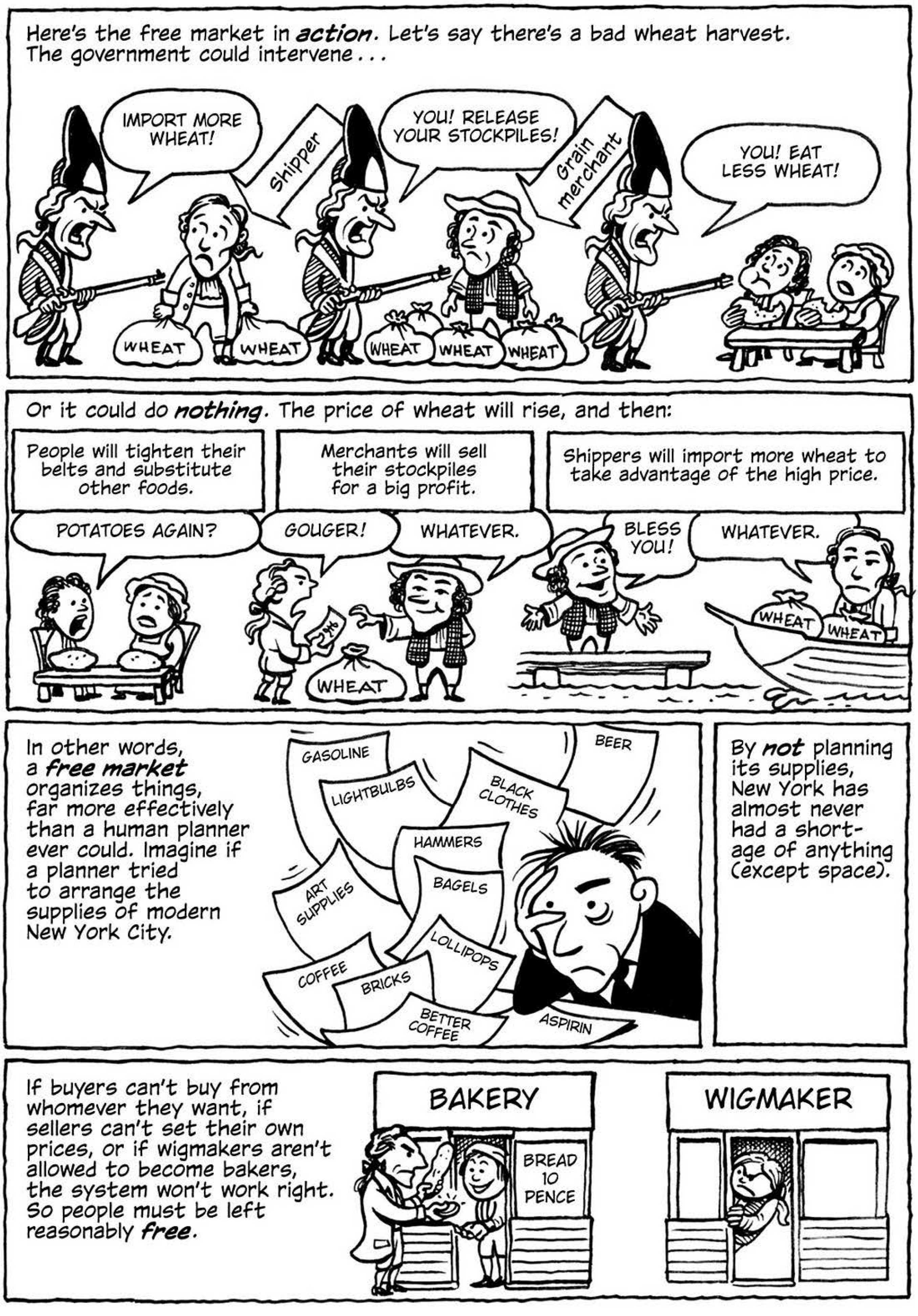

THAT'S PRETTY WACKY; HERE IT IS *DECODED* (YOU'LL HAVE TO TAKE MY WORD FOR IT).
FARMERS *MAKE* THE WEALTH.
LANDLORDS *TAKE* IT.
EVERYONE ELSE IS IRRELEVANT.
300
150
75
37.5
18.75
300
150
75
37.5
18.75
Quesnay's table was actually a decent description of the *farming* economy France was growing out of. And much of France hadn't grown out of it yet.
SEE?
But the *real* story was the rising capitalist economy.
SHIPPER
SMITH
INSURANCE
BAKER
BUTCHER
BREWER
BANK
Who would explain capitalism? Let's cross the English Channel and check out a Scottish economist, **Adam Smith** (1723-1790).

ADAM SMITH AND THE FREE MARKET




The pin workshop had a clear organization—one person gave the orders.
BUT WHO GAVE THE ORDERS TO ALL THE PEOPLE WHO WORKED ON BIGGER TASKS, LIKE MAKING A LOAF OF BREAD?
BAKERY
BREAD / 3 PENCE
Nobody did. Bakers didn't work because some Bread Planner told them to, or because they were saints who wanted people to be well fed. They worked because it was good for *them*.
"IT IS NOT FROM THE BENEVOLENCE OF THE BUTCHER, THE BREWER, AND THE BAKER, THAT WE EXPECT OUR DINNER, BUT FROM THEIR REGARD TO THEIR OWN INTEREST."
But if the baker cared only about himself, why didn't he do *this*?
BREAD / 10 PENCE


Smith's answer:
THE BAKER MIGHT *WANT* TO GOUGE, BUT IF HE TRIES, OTHER BAKERS, THINKING ONLY OF THEMSELVES, WILL STEAL HIS CUSTOMERS.
BAKERY
BREAD 10 pence
BAKERY
BREAD 3 pence
EVEN IF HE'S THE ONLY BAKER IN TOWN, HE CAN'T GET TOO GREEDY. IF HE STARTS MAKING CRAZY MONEY, OTHER PEOPLE WILL DROP WHAT THEY'RE DOING AND *HORN IN*.
BAKERY
BREAD 10 pence
~~WIGMAKER~~ BAKERY
BREAD 5 pence
So in Smith's economy, ***competition*** kept everyone honest. Every baker—saint and greedhead alike—was led, "as if by an invisible hand," to sell bread at a fair price: high enough to pay for the baker's costs and work, low enough that others didn't steal the customers.
BAKERY
BREAD 3 pence
I WANT TO CHARGE MORE, BUT I CAN'T!
~~WIGMAKER~~ BAKERY
Speaking of costs, the baker's suppliers, workers, landlord, and lenders couldn't overcharge either, or the baker would go to their competitors. And so on.
So the price of a loaf of bread included the fair price of all the land, labor, and capital that went into it—in other words, the bread sold for its cost to society.
MORE OR LESS.


Here's the free market in ***action***. Let's say there's a bad wheat harvest.
The government could intervene...
IMPORT MORE WHEAT!
Shipper
WHEAT
WHEAT
YOU! RELEASE YOUR STOCKPILES!
Grain merchant
WHEAT
WHEAT
WHEAT
YOU! EAT LESS WHEAT!
Or it could do ***nothing***. The price of wheat will rise, and then:
People will tighten their belts and substitute other foods.
POTATOES AGAIN?
Merchants will sell their stockpiles for a big profit.
GOUGER!
WHATEVER.
WHEAT
Shippers will import more wheat to take advantage of the high price.
BLESS YOU!
WHATEVER.
WHEAT
WHEAT
In other words, a ***free market*** organizes things, far more effectively than a human planner ever could. Imagine if a planner tried to arrange the supplies of modern New York City.
GASOLINE
BEER
LIGHTBULBS
BLACK CLOTHES
HAMMERS
BAGELS
ART SUPPLIES
LOLLIPOPS
COFFEE
BRICKS
BETTER COFFEE
ASPIRIN
By ***not*** planning its supplies, New York has almost never had a shortage of anything (except space).
If buyers can't buy from whomever they want, if sellers can't set their own prices, or if wigmakers aren't allowed to become bakers, the system won't work right. So people must be left reasonably ***free***.
BAKERY
BREAD 10 PENCE
WIGMAKER

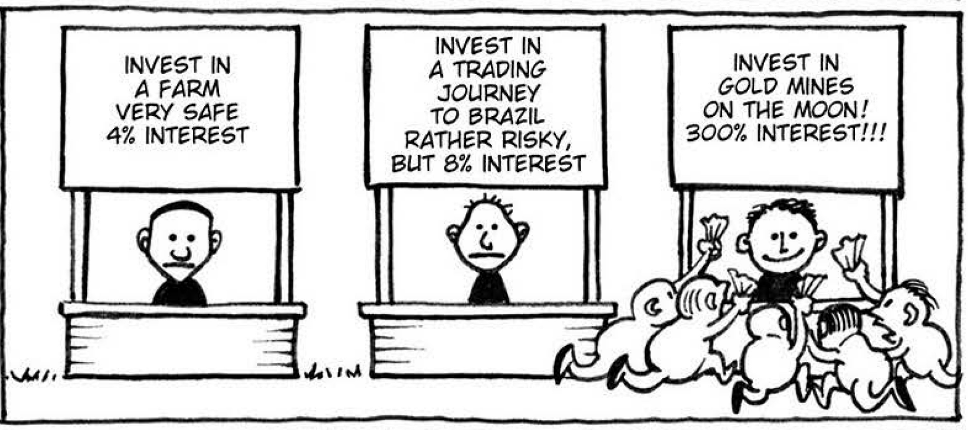

So we're back to:
LAISSEZ-FAIRE!
But now we understand why:
PINS
100 FOR A PENNY
1¢
• To **get**, people have to **give**—they have to sell something others want.
• If someone tries to charge too much, others will horn in until the price drops.
• So everything sells for roughly the cost of the land, labor, and capital it took to make the item.
IN OTHER WORDS, ITS COST TO **SOCIETY**.
If people **don't** buy a product, it means the product's not worth the cost of the resources used to make it. The seller goes out of business, freeing up the land, labor, and capital he was wasting.
LOVINGLY HANDCRAFTED PINS
1 FOR A PENNY
NO GREAT LOSS!
SO IN SMITH'S ECONOMY, THE **MARKET ITSELF** FIGURED OUT WHAT PEOPLE WANTED, AND HOW TO GET IT TO THEM MOST EFFICIENTLY, EVEN THOUGH EVERYONE **IN** THE MARKET WAS JUST TRYING TO MAKE A LIVING.
SMITH'S IDEA THAT THE MARKET CAN PROVIDE **ORDER** WITHOUT ANYONE GIVING **ORDERS** HAS BEEN THE CORE OF ECONOMIC THOUGHT EVER SINCE.
WEALTH OF NATIONS
BUT IT SOMETIMES SEEMS THAT PEOPLE SPEND MORE TIME **REVERING** ADAM SMITH THAN **READING** HIM. SMITH HAD **OTHER** THINGS TO SAY, THINGS THAT HAVE BEEN LARGELY FORGOTTEN. LET'S LOOK AT SOME OF THEM.

THE LIMITS OF THE MARKET

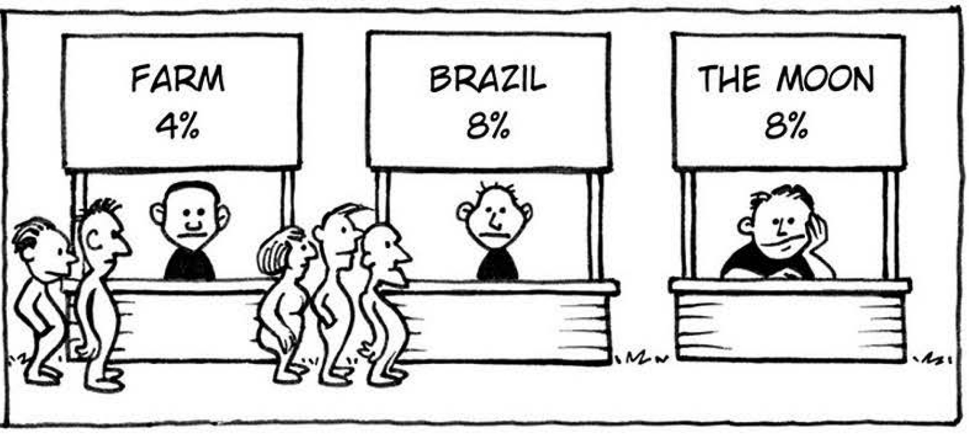
Adam Smith was never dogmatic; he knew markets weren't perfect. Markets won't enforce laws, protect borders, or provide ***public goods***, such as street cleaning, that everyone wants but nobody has much incentive to provide.

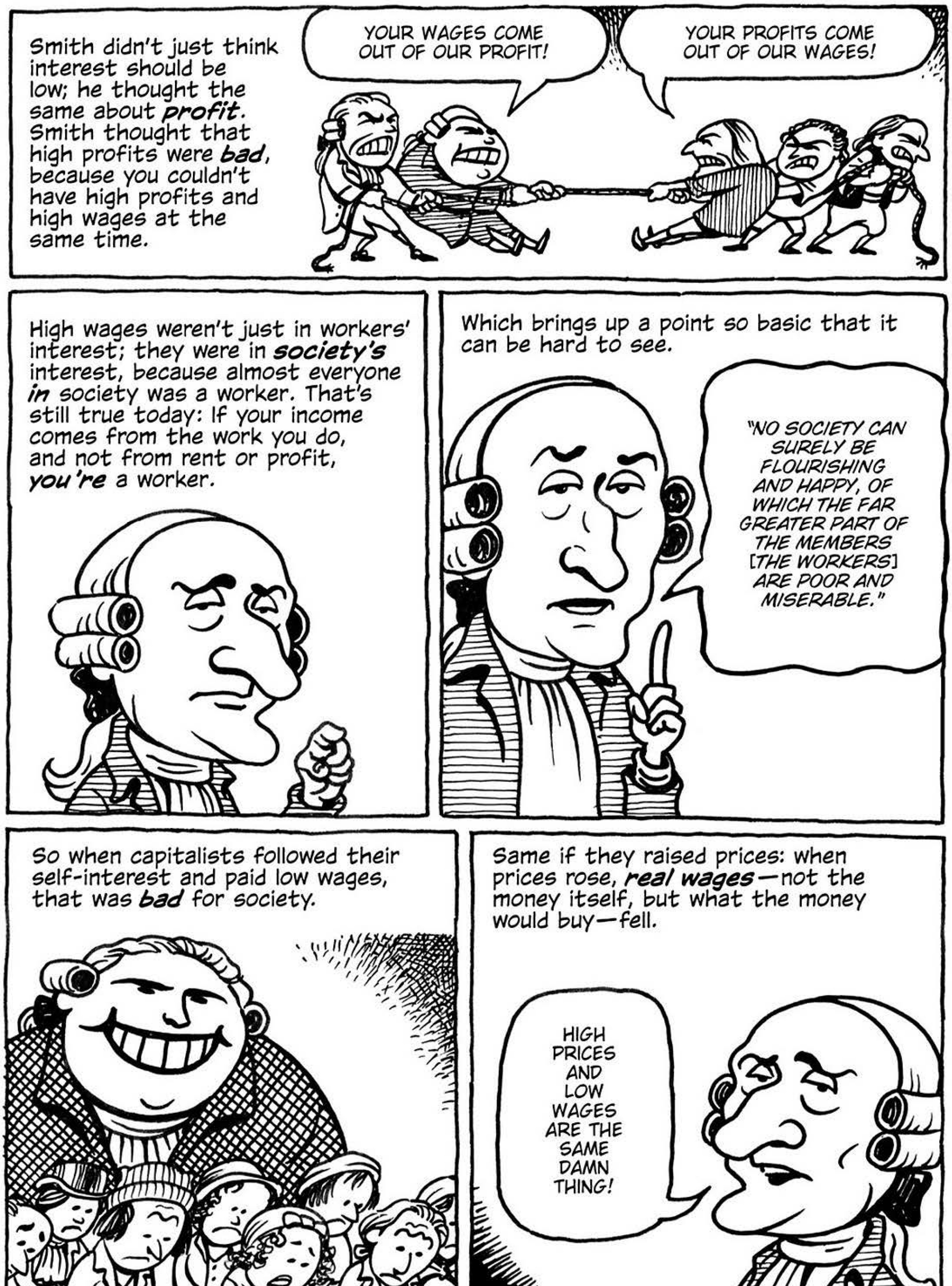
For that matter, Smith thought government should favor war-related industries so they would be around if war came, protect wage workers (because they had less bargaining power than employers), keep banks honest, issue patents, protect new industries until they were on their feet, cap the interest rate, control disease, establish education standards (so brain-dead ***jobs*** like the ones in the pin workshop didn't turn workers into brain-dead ***people***), and even provide public amusements.

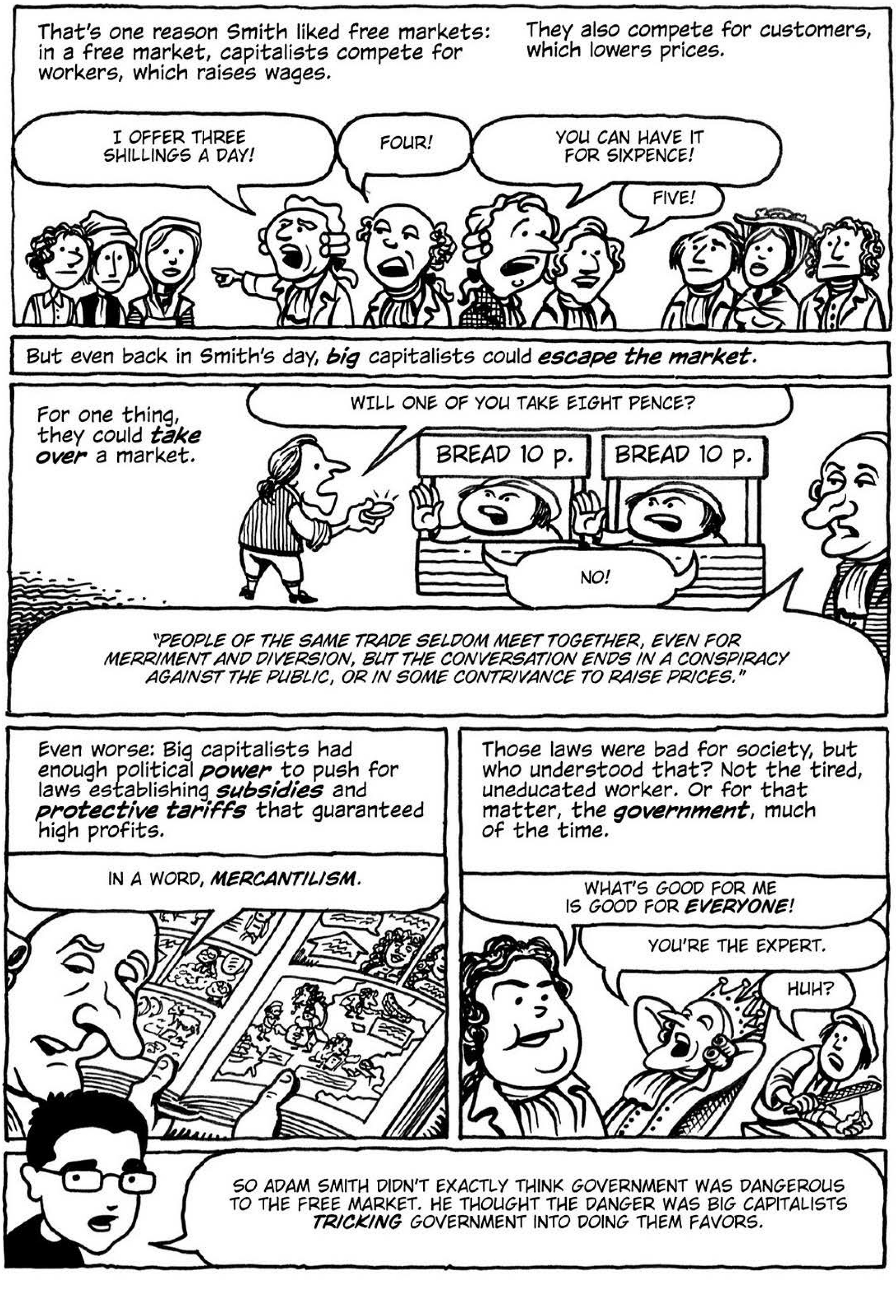
"Cap the interest rate" was a big one. Smith understood that if the reward gets too big, investors forget the ***risk***.



With the interest rate capped, Smith expected people to take reasonable risks but avoid wild gambles.

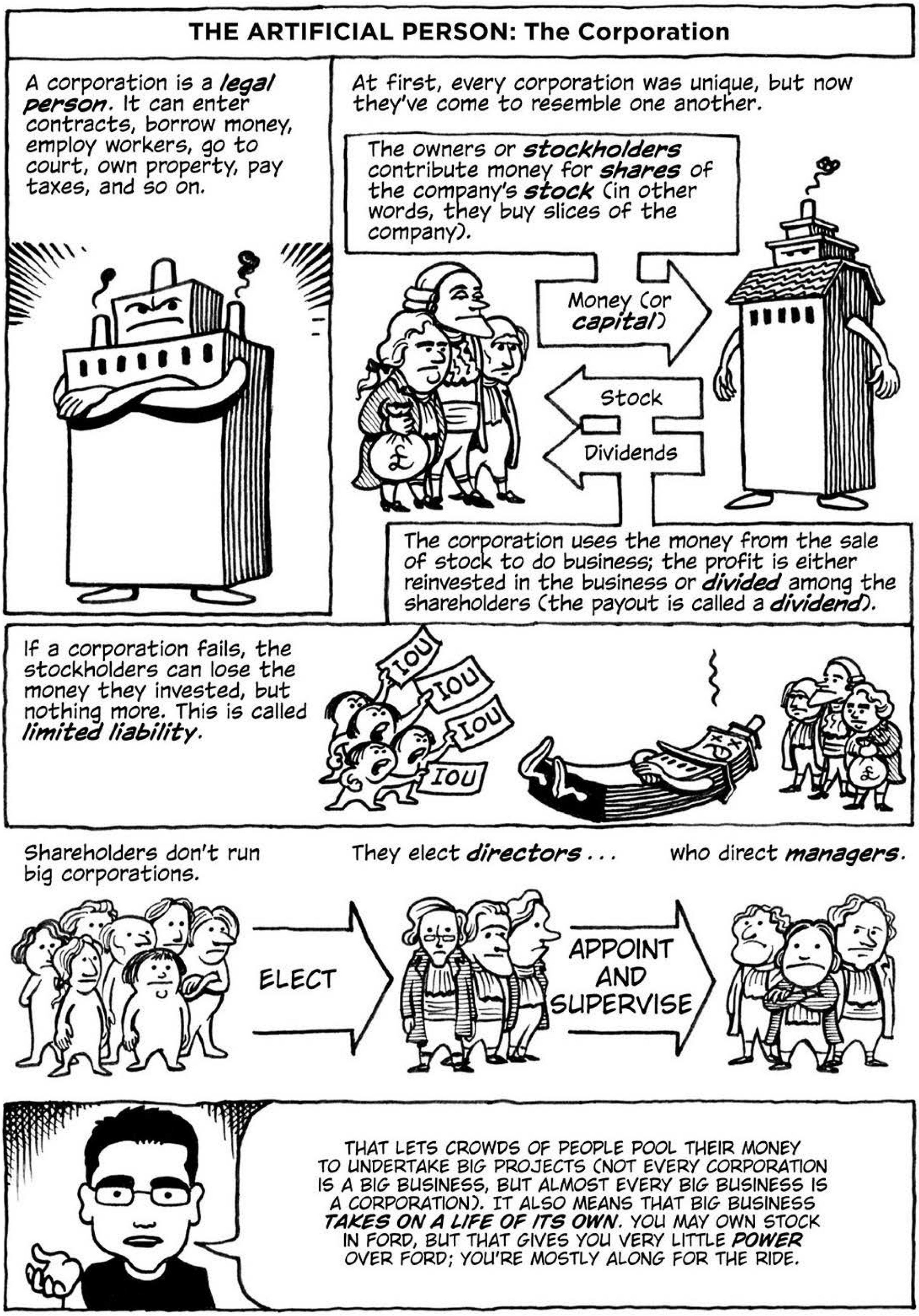


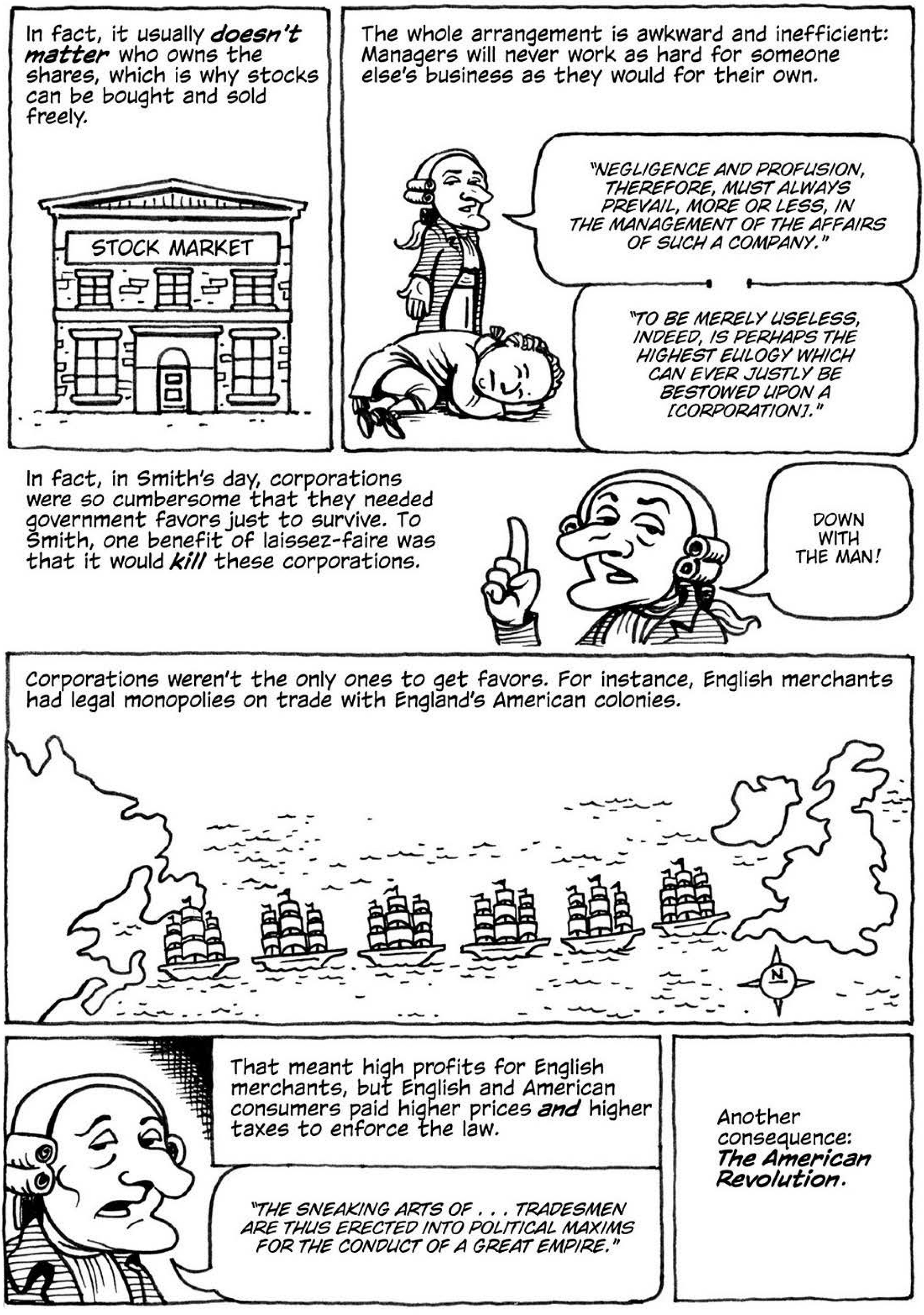

Smith didn't just think interest should be low; he thought the same about ***profit***. Smith thought that high profits were ***bad***, because you couldn't have high profits and high wages at the same time.
YOUR WAGES COME OUT OF OUR PROFIT!
YOUR PROFITS COME OUT OF OUR WAGES!
High wages weren't just in workers' interest; they were in ***society's*** interest, because almost everyone ***in*** society was a worker. That's still true today: If your income comes from the work you do, and not from rent or profit, ***you're*** a worker.
Which brings up a point so basic that it can be hard to see.
"NO SOCIETY CAN SURELY BE FLOURISHING AND HAPPY, OF WHICH THE FAR GREATER PART OF THE MEMBERS [THE WORKERS] ARE POOR AND MISERABLE."
So when capitalists followed their self-interest and paid low wages, that was ***bad*** for society.
Same if they raised prices: when prices rose, ***real wages***—not the money itself, but what the money would buy—fell.
HIGH PRICES AND LOW WAGES ARE THE SAME DAMN THING!



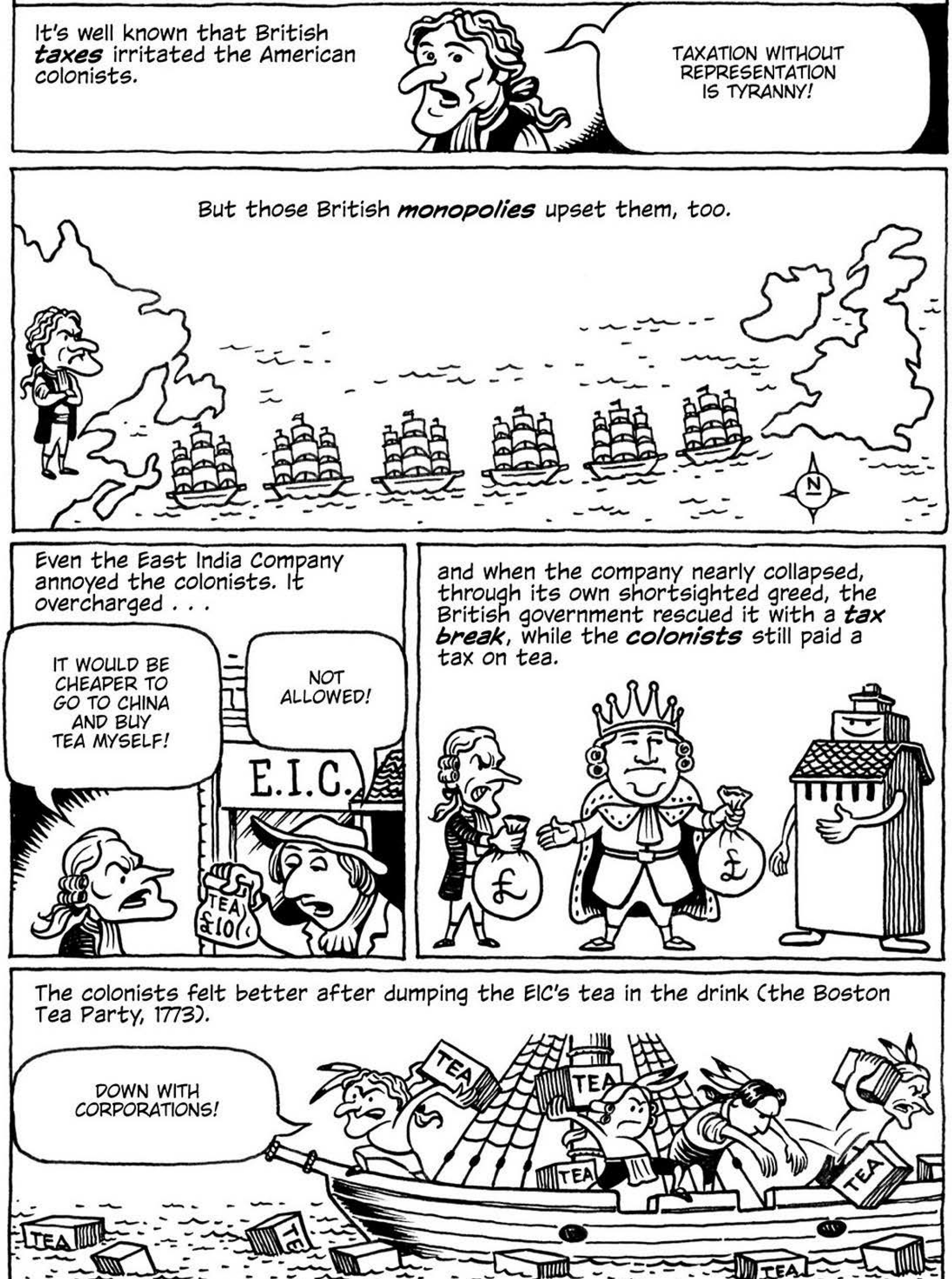
That's one reason Smith liked free markets: in a free market, capitalists compete for workers, which raises wages.
They also compete for customers, which lowers prices.
I OFFER THREE SHILLINGS A DAY!
FOUR!
YOU CAN HAVE IT FOR SIXPENCE!
FIVE!
But even back in Smith's day, ***big*** capitalists could ***escape the market***.
For one thing, they could ***take over*** a market.
WILL ONE OF YOU TAKE EIGHT PENCE?
BREAD 10 p.
BREAD 10 p.
NO!
"PEOPLE OF THE SAME TRADE SELDOM MEET TOGETHER, EVEN FOR MERRIMENT AND DIVERSION, BUT THE CONVERSATION ENDS IN A CONSPIRACY AGAINST THE PUBLIC, OR IN SOME CONTRIVANCE TO RAISE PRICES."
Even worse: Big capitalists had enough political ***power*** to push for laws establishing ***subsidies*** and ***protective tariffs*** that guaranteed high profits.
IN A WORD, ***MERCANTILISM***.
Those laws were bad for society, but who understood that? Not the tired, uneducated worker. Or for that matter, the ***government***, much of the time.
WHAT'S GOOD FOR ME IS GOOD FOR ***EVERYONE***!
YOU'RE THE EXPERT.
HUH?
SO ADAM SMITH DIDN'T EXACTLY THINK GOVERNMENT WAS DANGEROUS TO THE FREE MARKET. HE THOUGHT THE DANGER WAS BIG CAPITALISTS ***TRICKING*** GOVERNMENT INTO DOING THEM FAVORS.

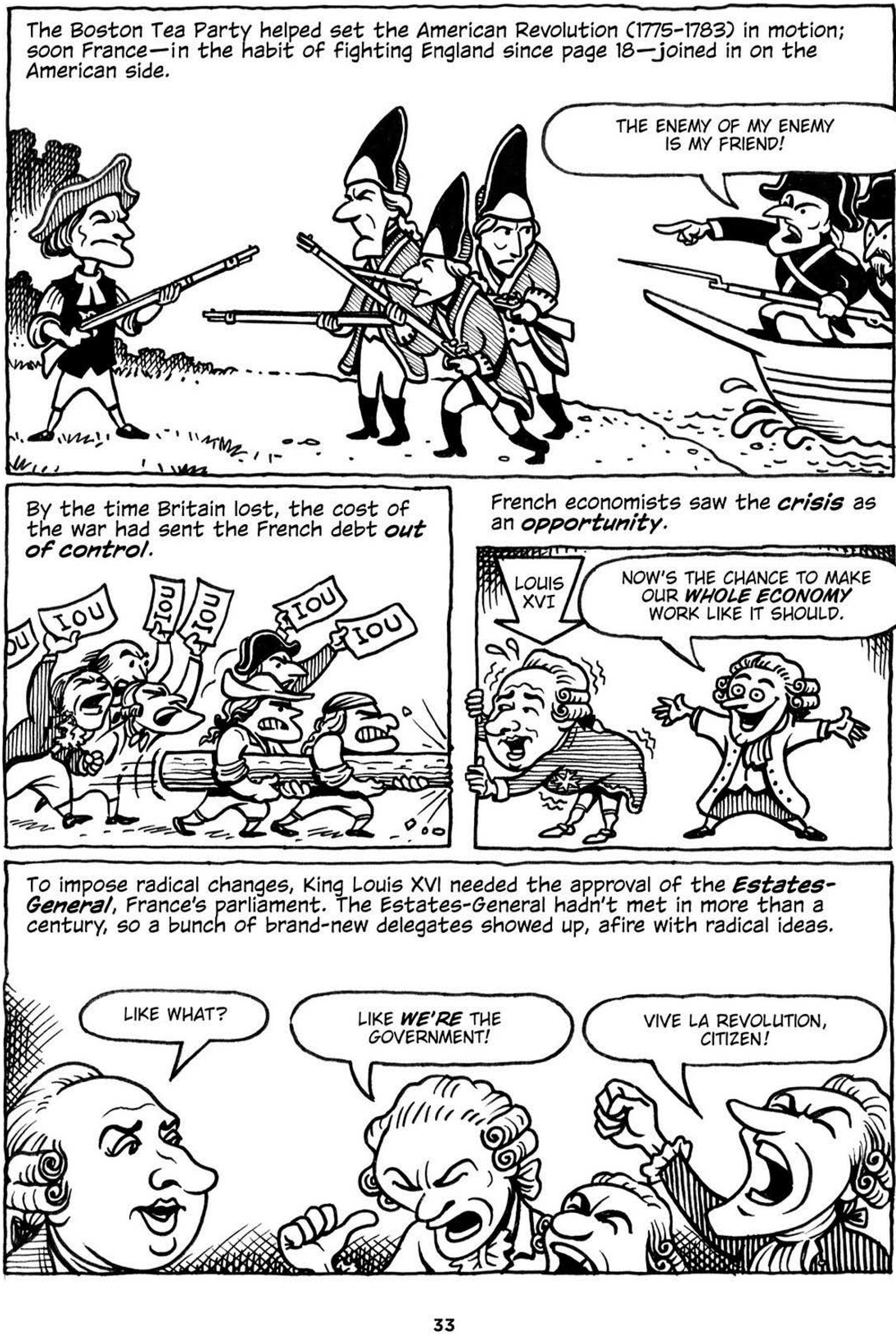

Which brings us to the big ***forgotten message*** of *The Wealth of Nations*:
BEWARE OF CAPITALISTS!
It's worth reading in Adam Smith's own words.
"THE PROPOSAL OF ANY NEW LAW OR REGULATION OF COMMERCE WHICH COMES FROM [CAPITALISTS] OUGHT ALWAYS TO BE LISTENED TO WITH GREAT PRECAUTION, AND OUGHT NEVER TO BE ADOPTED, TILL AFTER HAVING BEEN LONG AND CAREFULLY EXAMINED, NOT ONLY WITH THE MOST SCRUPULOUS, BUT WITH THE MOST SUSPICIOUS ATTENTION. IT COMES FROM AN ORDER OF MEN, WHOSE INTEREST IS NEVER EXACTLY THE SAME WITH THAT OF THE PUBLIC, WHO HAVE GENERALLY AN INTEREST TO DECEIVE AND EVEN TO OPPRESS THE PUBLIC, AND WHO ACCORDINGLY HAVE, UPON MANY OCCASIONS, BOTH DECEIVED AND OPPRESSED IT."
Smith had a bit of a ***problem*** with big capitalists.
"THE MEAN RAPACITY, THE MONOPOLIZING SPIRIT OF MERCHANTS AND MANUFACTURERS, WHO NEITHER ARE, NOR OUGHT TO BE, THE MASTERS OF MANKIND..."
And for good reason. Britain's economy was freer than France's (Smith thought that was why Britain was richer), but it was still riddled with regulations, subsidies, protections, and especially ***government-enforced monopolies***.
A ***monopoly*** is when there's only ***one*** seller in a market. With no competition, the monopolist can—and will—overcharge.
BREAD 10 pence
For instance, in Smith's day only the giant East India Company could trade with Asia.
OUR MONOPOLY ***ENCOURAGES*** US TO TRADE WITH ASIA!
THAT MAKES NO SENSE! IF THE ASIA TRADE PAYS, WHY KEEP PEOPLE OUT OF IT? IF IT DOESN'T, WHY ENCOURAGE IT?
The very ***existence*** of the East India Company was an interference in the market—the EIC was a government-created entity called a ***corporation***.

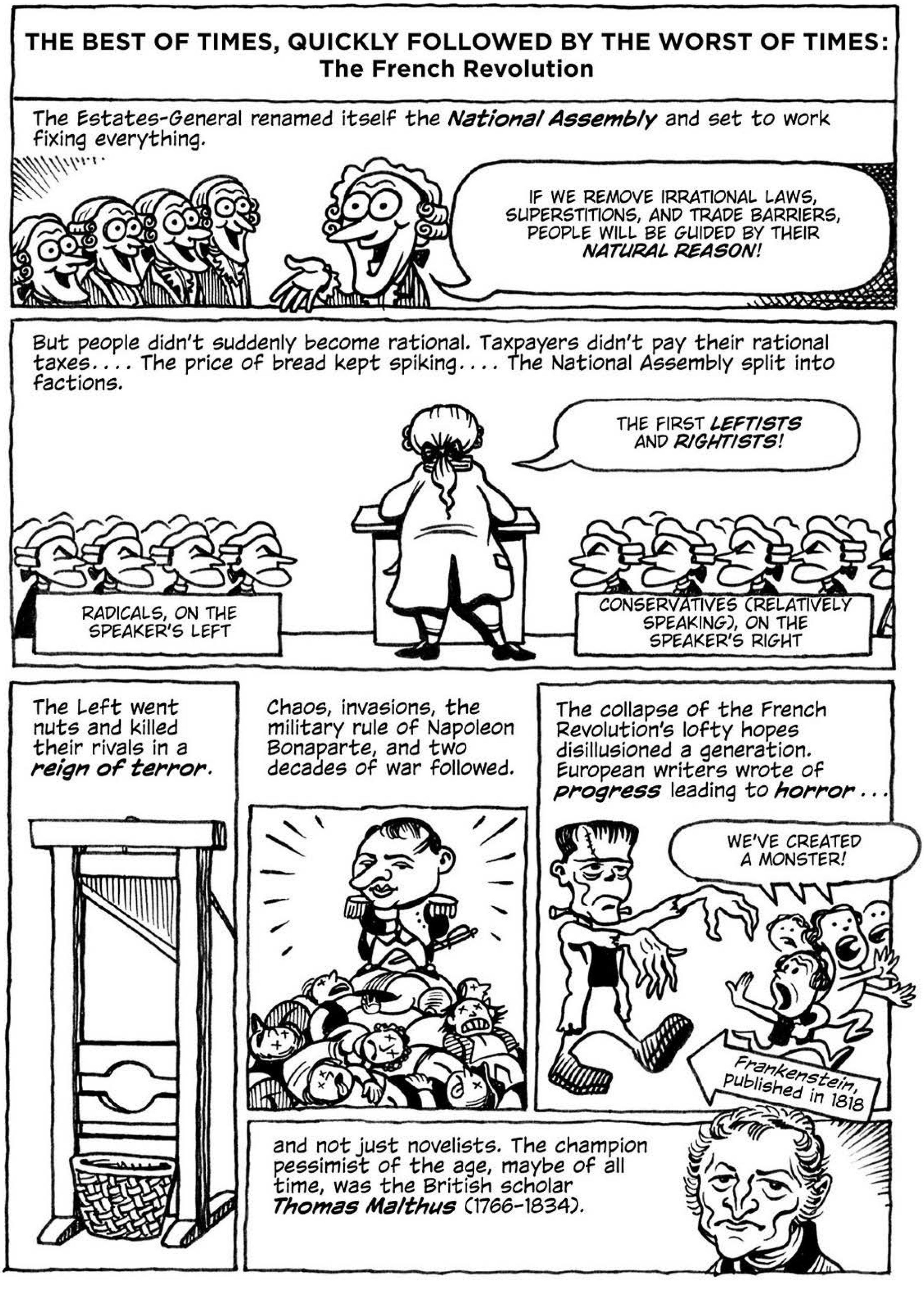

THE ARTIFICIAL PERSON: The Corporation
A corporation is a *legal person*. It can enter contracts, borrow money, employ workers, go to court, own property, pay taxes, and so on.
At first, every corporation was unique, but now they've come to resemble one another.
The owners or *stockholders* contribute money for *shares* of the company's *stock* (in other words, they buy slices of the company).
Money (or *capital*)
Stock
Dividends
The corporation uses the money from the sale of stock to do business; the profit is either reinvested in the business or *divided* among the shareholders (the payout is called a *dividend*).
If a corporation fails, the stockholders can lose the money they invested, but nothing more. This is called *limited liability*.
IOU
IOU
IOU
IOU
Shareholders don't run big corporations.
They elect *directors* . . .
who direct *managers*.
ELECT
APPOINT AND SUPERVISE
THAT LETS CROWDS OF PEOPLE POOL THEIR MONEY TO UNDERTAKE BIG PROJECTS (NOT EVERY CORPORATION IS A BIG BUSINESS, BUT ALMOST EVERY BIG BUSINESS IS A CORPORATION). IT ALSO MEANS THAT BIG BUSINESS *TAKES ON A LIFE OF ITS OWN*. YOU MAY OWN STOCK IN FORD, BUT THAT GIVES YOU VERY LITTLE *POWER* OVER FORD; YOU'RE MOSTLY ALONG FOR THE RIDE.

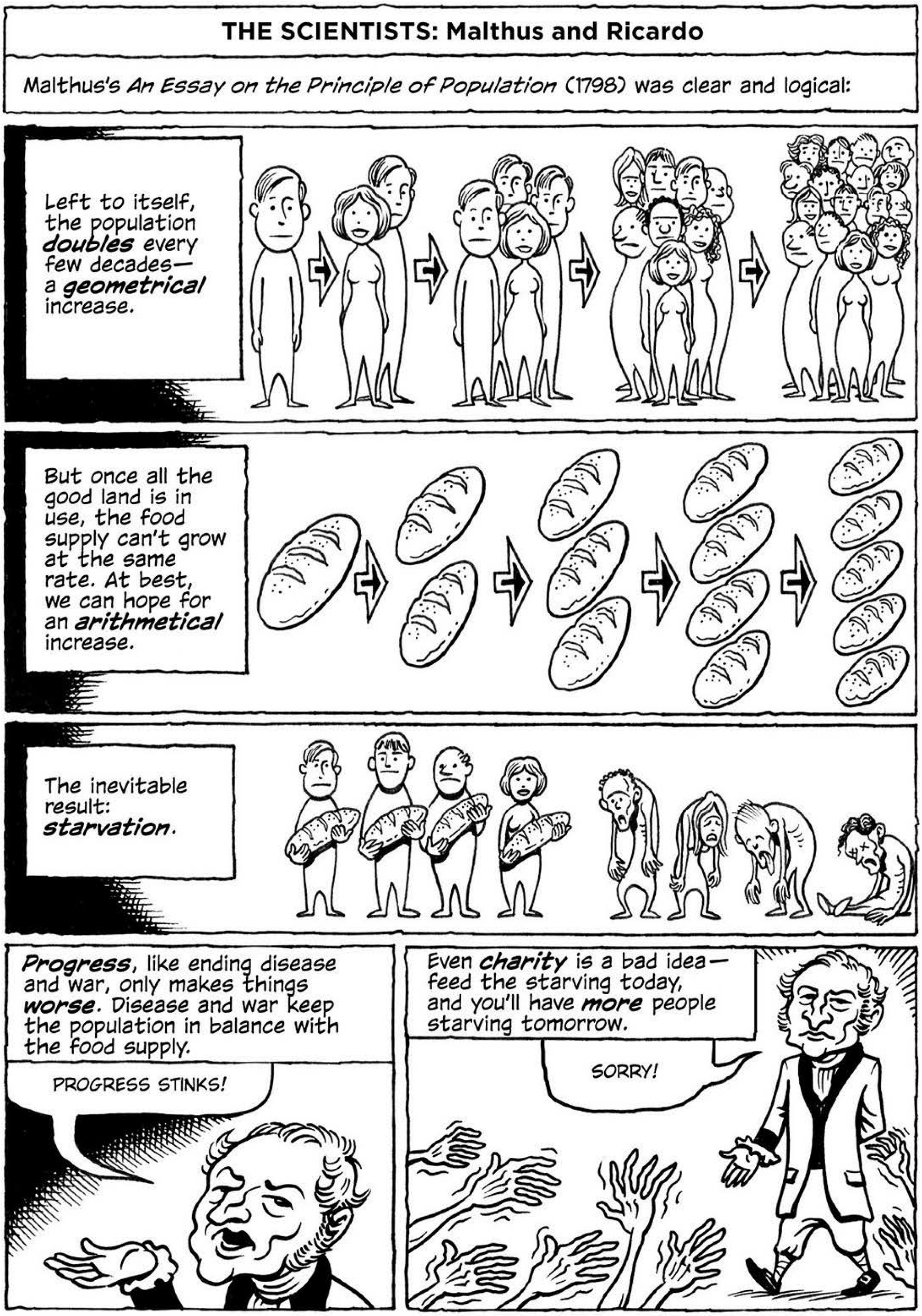

In fact, it usually **doesn't matter** who owns the shares, which is why stocks can be bought and sold freely.
STOCK MARKET
The whole arrangement is awkward and inefficient: Managers will never work as hard for someone else's business as they would for their own.
"NEGLIGENCE AND PROFUSION, THEREFORE, MUST ALWAYS PREVAIL, MORE OR LESS, IN THE MANAGEMENT OF THE AFFAIRS OF SUCH A COMPANY."
"TO BE MERELY USELESS, INDEED, IS PERHAPS THE HIGHEST EULOGY WHICH CAN EVER JUSTLY BE BESTOWED UPON A [CORPORATION]."
In fact, in Smith's day, corporations were so cumbersome that they needed government favors just to survive. To Smith, one benefit of laissez-faire was that it would ***kill*** these corporations.
DOWN WITH THE MAN!
Corporations weren't the only ones to get favors. For instance, English merchants had legal monopolies on trade with England's American colonies.
N
That meant high profits for English merchants, but English and American consumers paid higher prices ***and*** higher taxes to enforce the law.
"THE SNEAKING ARTS OF . . . TRADESMEN ARE THUS ERECTED INTO POLITICAL MAXIMS FOR THE CONDUCT OF A GREAT EMPIRE."
Another consequence: ***The American Revolution***.

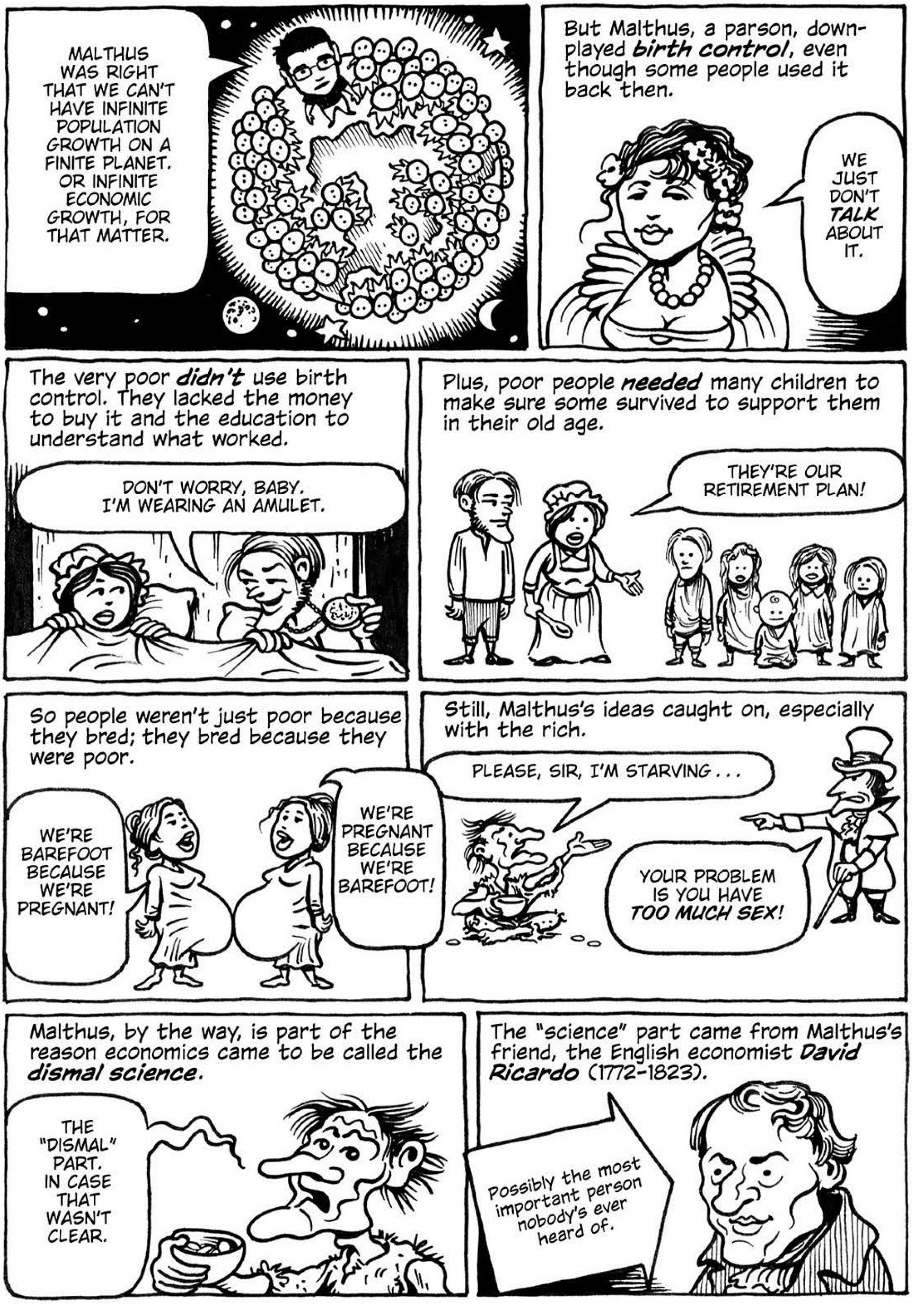
LIBERTY OR DEATH: The American Revolution

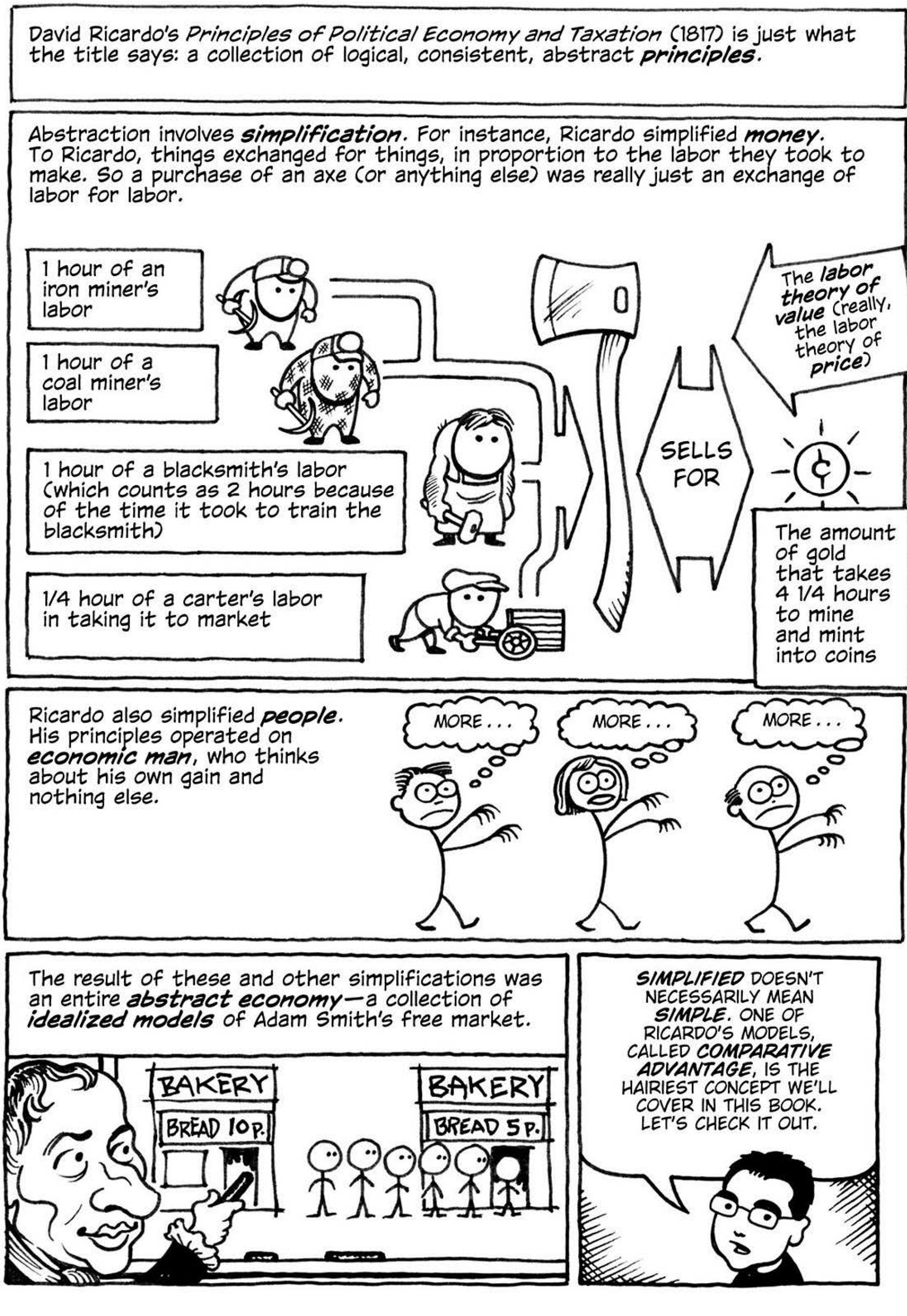



The Boston Tea Party helped set the American Revolution (1775-1783) in motion; soon France—in the habit of fighting England since page 18—joined in on the American side.
THE ENEMY OF MY ENEMY IS MY FRIEND!
By the time Britain lost, the cost of the war had sent the French debt ***out of control***.
IOU
IOU
IOU
IOU
IOU
IOU
French economists saw the ***crisis*** as an ***opportunity***.
LOUIS XVI
NOW'S THE CHANCE TO MAKE OUR ***WHOLE ECONOMY*** WORK LIKE IT SHOULD.
To impose radical changes, King Louis XVI needed the approval of the ***Estates-General***, France's parliament. The Estates-General hadn't met in more than a century, so a bunch of brand-new delegates showed up, afire with radical ideas.
LIKE WHAT?
LIKE ***WE'RE*** THE GOVERNMENT!
VIVE LA REVOLUTION, CITIZEN!


THE BEST OF TIMES, QUICKLY FOLLOWED BY THE WORST OF TIMES:
The French Revolution
The Estates-General renamed itself the *National Assembly* and set to work fixing everything.
IF WE REMOVE IRRATIONAL LAWS, SUPERSTITIONS, AND TRADE BARRIERS, PEOPLE WILL BE GUIDED BY THEIR *NATURAL REASON*!
But people didn't suddenly become rational. Taxpayers didn't pay their rational taxes. . . . The price of bread kept spiking. . . . The National Assembly split into factions.
THE FIRST *LEFTISTS* AND *RIGHTISTS*!
RADICALS, ON THE SPEAKER'S LEFT
CONSERVATIVES (RELATIVELY SPEAKING), ON THE SPEAKER'S RIGHT
The Left went nuts and killed their rivals in a *reign of terror*.
Chaos, invasions, the military rule of Napoleon Bonaparte, and two decades of war followed.
The collapse of the French Revolution's lofty hopes disillusioned a generation. European writers wrote of *progress* leading to *horror* . . .
WE'VE CREATED A MONSTER!
Frankenstein, published in 1818
and not just novelists. The champion pessimist of the age, maybe of all time, was the British scholar *Thomas Malthus* (1766–1834).

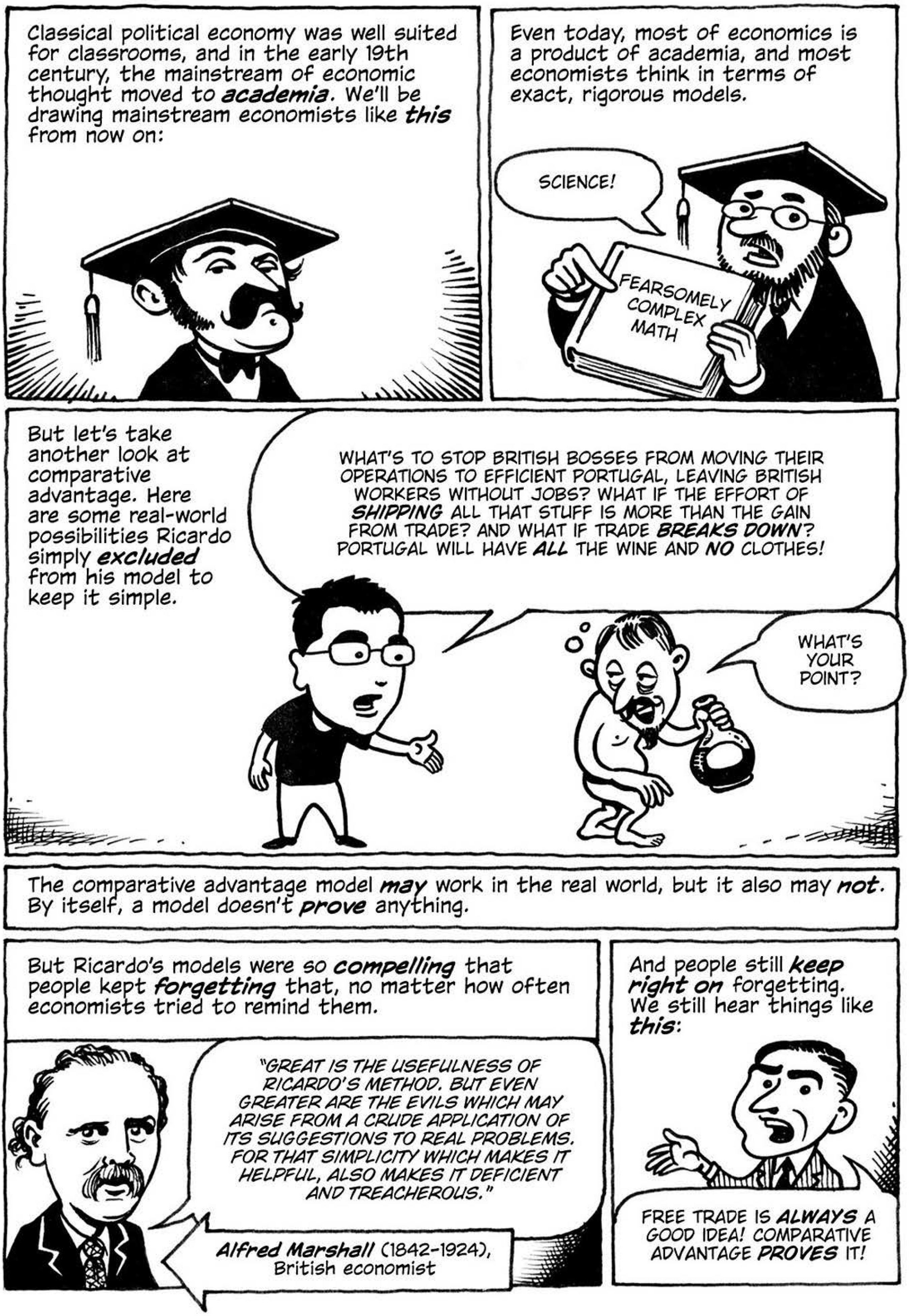

THE SCIENTISTS: Malthus and Ricardo
Malthus's *An Essay on the Principle of Population* (1798) was clear and logical:
Left to itself, the population ***doubles*** every few decades—a ***geometrical*** increase.
But once all the good land is in use, the food supply can't grow at the same rate. At best, we can hope for an ***arithmetical*** increase.
The inevitable result: ***starvation***.
Progress, like ending disease and war, only makes things ***worse***. Disease and war keep the population in balance with the food supply.
PROGRESS STINKS!
Even ***charity*** is a bad idea—feed the starving today, and you'll have ***more*** people starving tomorrow.
SORRY!

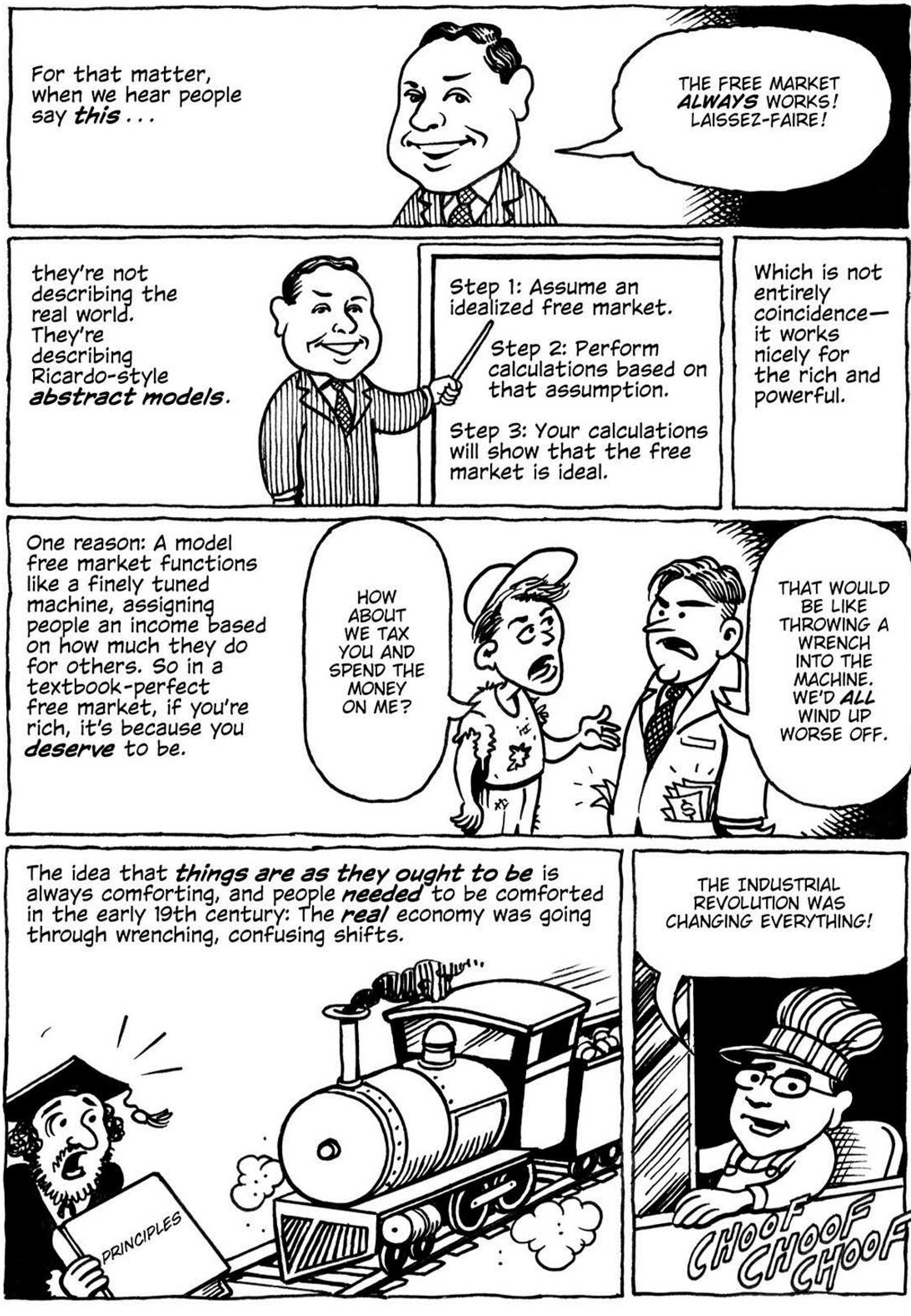

MALTHUS WAS RIGHT THAT WE CAN'T HAVE INFINITE POPULATION GROWTH ON A FINITE PLANET. OR INFINITE ECONOMIC GROWTH, FOR THAT MATTER.
But Malthus, a parson, downplayed birth control, even though some people used it back then.
WE JUST DON'T TALK ABOUT IT.
The very poor didn't use birth control. They lacked the money to buy it and the education to understand what worked.
DON'T WORRY, BABY. I'M WEARING AN AMULET.
Plus, poor people needed many children to make sure some survived to support them in their old age.
THEY'RE OUR RETIREMENT PLAN!
So people weren't just poor because they bred; they bred because they were poor.
WE'RE BAREFOOT BECAUSE WE'RE PREGNANT!
WE'RE PREGNANT BECAUSE WE'RE BAREFOOT!
Still, Malthus's ideas caught on, especially with the rich.
PLEASE, SIR, I'M STARVING . . .
YOUR PROBLEM IS YOU HAVE TOO MUCH SEX!
Malthus, by the way, is part of the reason economics came to be called the dismal science.
THE "DISMAL" PART. IN CASE THAT WASN'T CLEAR.
The "science" part came from Malthus's friend, the English economist David Ricardo (1772-1823).
Possibly the most important person nobody's ever heard of.


David Ricardo's *Principles of Political Economy and Taxation* (1817) is just what the title says: a collection of logical, consistent, abstract ***principles***.
Abstraction involves ***simplification***. For instance, Ricardo simplified ***money***. To Ricardo, things exchanged for things, in proportion to the labor they took to make. So a purchase of an axe (or anything else) was really just an exchange of labor for labor.
1 hour of an iron miner's labor
1 hour of a coal miner's labor
1 hour of a blacksmith's labor (which counts as 2 hours because of the time it took to train the blacksmith)
1/4 hour of a carter's labor in taking it to market
SELLS FOR
The ***labor theory of value*** (really, the labor theory of ***price***)
¢
The amount of gold that takes 4 1/4 hours to mine and mint into coins
Ricardo also simplified ***people***. His principles operated on ***economic man***, who thinks about his own gain and nothing else.
MORE . . .
MORE . . .
MORE . . .
The result of these and other simplifications was an entire ***abstract economy***—a collection of ***idealized models*** of Adam Smith's free market.
BAKERY
BREAD 10p.
BAKERY
BREAD 5p.
SIMPLIFIED DOESN'T NECESSARILY MEAN ***SIMPLE***. ONE OF RICARDO'S MODELS, CALLED ***COMPARATIVE ADVANTAGE***, IS THE HAIRIEST CONCEPT WE'LL COVER IN THIS BOOK. LET'S CHECK IT OUT.


In this model, Ricardo *excluded* all countries except England and Portugal, and all products except wine and clothes.
Obviously, if each country makes one thing more efficiently, it makes sense to specialize and *trade*.
YOU MAKE WINE; WE'LL MAKE CLOTHES!
1 worker makes 2 casks of wine or 4 bundles of clothes per year.
1 worker makes 4 casks of wine or 2 bundles of clothes per year.
Now let's imagine England is just plain *inefficient*. Does trade still make sense? Common sense says *no*.
WE'RE AT A *DISADVANTAGE* HERE. IF WE LET YOUR CHEAP GOODS IN, THEY'D SWAMP US!
WHY WOULD WE *TRADE* FOR THINGS WE CAN *MAKE* FASTER?
1 worker makes 2 casks of wine or 4 bundles of clothes per year.
1 worker makes 4 casks of wine or 6 bundles of clothes per year.
BUT WAIT: IF ENGLAND SWITCHES, SAY, 100 WORKERS FROM MAKING WINE TO MAKING CLOTHES, YOU'LL MAKE 200 FEWER CASKS OF WINE BUT 400 MORE BUNDLES OF CLOTHES. SEND PORTUGAL 380 BUNDLES AND YOU'LL STILL HAVE 20 *MORE* THAN YOU STARTED WITH.
RIGHT. . . . SO?

Adam Smith is often called a classical economist, but really he was very different; his rich tapestry of real butchers and bakers making real decisions didn't much resemble the abstract, theoretical world of classical political economy.


Classical political economy was well suited for classrooms, and in the early 19th century, the mainstream of economic thought moved to *academia*. We'll be drawing mainstream economists like *this* from now on:
Even today, most of economics is a product of academia, and most economists think in terms of exact, rigorous models.
SCIENCE!
FEARSOMELY COMPLEX MATH
But let's take another look at comparative advantage. Here are some real-world possibilities Ricardo simply *excluded* from his model to keep it simple.
WHAT'S TO STOP BRITISH BOSSES FROM MOVING THEIR OPERATIONS TO EFFICIENT PORTUGAL, LEAVING BRITISH WORKERS WITHOUT JOBS? WHAT IF THE EFFORT OF *SHIPPING* ALL THAT STUFF IS MORE THAN THE GAIN FROM TRADE? AND WHAT IF TRADE *BREAKS DOWN*? PORTUGAL WILL HAVE *ALL* THE WINE AND *NO* CLOTHES!
WHAT'S YOUR POINT?
The comparative advantage model *may* work in the real world, but it also may *not*. By itself, a model doesn't *prove* anything.
But Ricardo's models were so *compelling* that people kept *forgetting* that, no matter how often economists tried to remind them.
"GREAT IS THE USEFULNESS OF RICARDO'S METHOD. BUT EVEN GREATER ARE THE EVILS WHICH MAY ARISE FROM A CRUDE APPLICATION OF ITS SUGGESTIONS TO REAL PROBLEMS. FOR THAT SIMPLICITY WHICH MAKES IT HELPFUL, ALSO MAKES IT DEFICIENT AND TREACHEROUS."
Alfred Marshall (1842–1924), British economist
And people still *keep right on* forgetting. We still hear things like *this*:
FREE TRADE IS *ALWAYS* A GOOD IDEA! COMPARATIVE ADVANTAGE *PROVES* IT!


For that matter, when we hear people say ***this*** . . .
THE FREE MARKET ***ALWAYS*** WORKS! LAISSEZ-FAIRE!
they're not describing the real world. They're describing Ricardo-style ***abstract models***.
Step 1: Assume an idealized free market.
Step 2: Perform calculations based on that assumption.
Step 3: Your calculations will show that the free market is ideal.
Which is not entirely coincidence—it works nicely for the rich and powerful.
One reason: A model free market functions like a finely tuned machine, assigning people an income based on how much they do for others. So in a textbook-perfect free market, if you're rich, it's because you ***deserve*** to be.
HOW ABOUT WE TAX YOU AND SPEND THE MONEY ON ME?
THAT WOULD BE LIKE THROWING A WRENCH INTO THE MACHINE. WE'D ***ALL*** WIND UP WORSE OFF.
The idea that ***things are as they ought to be*** is always comforting, and people ***needed*** to be comforted in the early 19th century: The ***real*** economy was going through wrenching, confusing shifts.
PRINCIPLES
THE INDUSTRIAL REVOLUTION WAS CHANGING EVERYTHING!
CHOOF CHOOF CHOOF

The bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together. Subjection of nature's forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalization of rivers, whole populations conjured out of the ground – what earlier century had even a presentiment that such productive forces slumbered in the lap of social labour?

—Karl Marx and Friedrich Engels,
The Communist Manifesto (1848)