

A TREATISE FOR A NEW AGE IN ECONOMIC THEORY: REVIEW OF GEORGE REISMAN'S *CAPITALISM*

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CAPITALISM: A TREATISE ON ECONOMICS. By George Reisman.
Ottawa, IL: Jameson Books, 1996.

THE BOOK UNDER REVIEW, *Capitalism: A Treatise on Economics*,¹ has been in print since 1996. Its enormous size and the vast array of topics covered suggest enormous scholarship and devotion. Its expressed purpose is a thorough integration of leading economic phenomena into one unified theory of the market process. Yet virtually no serious attention on the part of academic economists has been paid to its many highly original contributions and bold challenges to received orthodoxy. This review aims at a compressed presentation and analysis of some of the book's main contributions to political economy, and hopes thereby to kick off a rigorous discussion of its substantive ideas.

To put the extent of George Reisman's intellectual achievement into a single sentence: for a full understanding of economic institutions of capitalism the reading and very careful studying of his *Capitalism: A Treatise on Economics* is absolutely essential. Nowhere will one find a clearer, more comprehensive, more rigorous, more persuasive and thus exactly for these reasons absolutely enthralling description and explanation of all leading economic institutions of capitalism.

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¹George Reisman (1996), *Capitalism: A Treatise on Economics*. Jameson Books, Ottawa, IL. A free pdf version of the book is also available on the author's website at www.capitalism.net.

Most of *Capitalism's* content is presented in the framework of a highly original and integrated theoretical system. In terms of doctrinal pedigree and analytical substance, Reisman conceives his system as a synthesis of the fundamental ideas of Austrian (particularly of Eugen von Böhm-Bawerk and Ludwig von Mises), British Classical economists (Adam Smith, David Ricardo, and John Stuart Mill), and, quite significantly, of the novelist-philosopher Ayn Rand whose conclusions are greatly reinforced and whose analytical coherency are enormously magnified by Reisman's own numerous theoretical innovations.² These innovations constitute the binding elements, as it were, which preserve what is true and discard what is false in the doctrines of both schools. Like a skillful sculptor, Reisman develops his argument all the while masterly cutting through doctrines and theorems, meticulously extracting and explaining the positive value of some and mercilessly exposing the analytical and empirical fallacies of others.

Exemplary of Reisman's intellectual vigor and independence, while acknowledging and praising highly Adam Smith's very valuable discussion of the distinction between productive and unproductive labor (p. 456 in *Capitalism*), is his devastating critique of Smith's ideas on the origin and nature of profit and wages, which found its most consequent logical development in the Marxian exploitation theory (pp. 475–82). Reisman credits numerous ideas of David Ricardo, acknowledges their significant impact on the direction and development of his own views on numerous problems in economics³, but at the same time rejects emphatically Ricardo's theory of the relationship between machinery and unemployment (Ricardo-effect)⁴, shows exhaustively that there is no tendency for the rate of profit to fall.⁵

The Austrian school is credited with the discovery of the principle of marginal utility, thus laying the groundwork for a correct theory of price formation. He shows how the principle of marginal utility analysis, as developed chiefly by Böhm-Bawerk in his neglected essay *Value, Cost, and*

²The very significant influence of Ayn Rand's philosophy, especially her epistemological theory, is acknowledged throughout the book.

³These include certain isolated elements in Ricardo's discussion on the relationship between profits and wages as well as the role of capital in the determination of nominal and real wages (pp. 797–98, 486). Especially noteworthy are Ricardo's views on cost of production and the role of utility in the process of price formation (p. 414). To a great extent they are compatible with Böhm-Bawerk's discussions on the subject.

⁴"This is the mistaken belief that a rise in wage rates encourages the use of machinery." (p. 798) Reisman's basic criticism is that, first of all, Ricardo confuses wage rates and the amount of wages. Reisman shows furthermore that "a rise in wage rates discourages the use of machinery fully as often as it encourages it." (pp. 798–99)

⁵The critique appears on pp. 799–801.

*Marginal Utility*⁶, leads to the important conclusion, almost entirely lost to contemporary microeconomics, that prices of commodities (i.e. reproducible goods which cover both capital and consumers' goods) are in most instances determined by their costs of production rather than directly by the marginal utility of the commodity in question. Yet it is still ultimately the marginal utility of consumers' goods that regulates prices of factors of production.

In a few words, Böhm-Bawerk's reconciles the two seemingly mutually exclusive doctrines as follows. A *given* supply of, say, iron ore (or any other input factor) can usually be employed in bringing forth supplies of a number of different consumers' good to which consumers attach *different* marginal utilities. According to the marginal principle, the unit market price of the entire supply of iron ore will be determined by the *relatively lowest* utility of the marginal unit of the *least* important consumer good, say, bicycle bell. The thus established price of iron ore determines the prices of all other more important consumers' goods, say, race car engines or high-tech medical equipment. The imputation goes back not directly, case-by-case, from the marginal utility of each type of consumers' good to the factor input in question but rather from the marginal unit of the *least* important consumers' good to the marginal unit of the input factor.

Austrians are furthermore credited with the discovery and elaboration of the important insight that under freedom of competition consumers and consumer spending help to direct, though by no means maintain, production and production plans of business firms.

But as with Classical economics, wherever Reisman finds analytical or empirical inconsistencies in Austrian economics, he mercilessly exposes them and brings the science of economics closer to a greater analytical tidiness and higher level of integration with observable facts and phenomena. For example, the highly influential Austrian time-preference approach to the phenomenon of ordinary interest (or profit), as originated again in the work of Böhm-Bawerk and brought to perfection in the writings of Fetter, Mises and Rothbard, is shown to be completely inadequate to both furnish a coherent explanation of the phenomenon of interest and remain consistent with wider conditions of the market (pp. 792–97).

For the sake of greater accuracy and to avoid confusion, it is necessary to make clear that Reisman regards the concept of time-preference as such as the “second major principle of valuation that closely bears on the subject of scarcity.” (pp. 55–58) Indeed, Reisman's own theory of profit/interest

⁶This lengthy essay did not appear in English until translated by Reisman and recently published in the *Quarterly Journal of Austrian Economics*, vol. 5, no. 3 (fall 2002), pp. 37–79.

depends critically on the fundamental idea of time-preference. The difference between what Reisman calls the *traditional* Austrian time-preference theory of Böhm-Bawerk *et al* and his own theory is that the traditional theory seeks to explain the phenomenon of profit/interest *directly* on the basis of intertemporal valuation of units of *physical goods*, while time-preference in Reisman's theory is an *indirect* determinant of the rate of profit/interest. "Time-preference, writes Reisman, determines the proportions in which people devote their income and wealth to present consumption versus provision for the future." (p. 743–44)

Briefly, the chain of causation runs as follows. A given degree of time preference will manifest itself *inversely* in a given provision for the future, i.e. savings, relative to present consumption. Under modern conditions of industry and trade, (money) savings usually enter the factor markets as *money* capital. It is precisely this capital that constitutes the financial means for the demand of factors of production (capital goods and labor services) in the economic system. And so, for example, the greater proportion of aggregate sales proceeds is saved and invested, echoing a lower degree of time-preference, the *lower* is the rate of profit/interest. The less capital invested, the *higher* is the rate of profit/interest. Thus, the concept of time-preference in Reisman's system enters the explanation of the rate of profit/interest via his equally original theories of saving and capital accumulation that describe and explain the process of income formation and distribution in a previously unknown and exciting way.

Naturally, in light of the consistently pro-reason and pro-capitalist tone of the book, one will find in *Capitalism* virtually nothing in favor of the economic doctrines of Marxism, Keynesianism as well as broad segments of neoclassical economics, particularly Samuelson's neoclassical synthesis in macroeconomics. Not a single important doctrine is neglected or dealt with insufficiently. To the contrary, chapters are devoted to very detailed, step-by-step expositions followed by no less detailed and absolutely devastating analytical blows against the structural integrity of those doctrines. Only after having read and absorbed Reisman's masterful exposition and critique of Marx and Keynes, I was able to follow through the actual mechanics and appreciate the full range of ideas in *Das Kapital* and *The General Theory*.

Perhaps the best place to grasp the essence of our author's distinctive analytical approach is his critique of the Marxian exploitation theory. The standard criticisms of Marxian system of economics focus on isolated instances of inner contradictions between the system and observed facts. For example, Böhm-Bawerk's famous, and widely perceived as the strongest

criticism of Marxian economics, *Karl Marx and the Close of His System*⁷, identifies and skillfully exploits a contradiction between Marxian labor theory of value of *Das Kapital I* and the average rate of profit of *Das Kapital III*.

Reisman goes much further into the substance and offers a much more comprehensive critique which, incidentally, is fully integrated into and informed by his overall analytical framework. The critique opens with a careful dissection of the fallacies in the distinctive conceptual-analytical core of the Marxian system and ends up with a complete implosion of its substance. According to Reisman, the ultimate source of all the numerous errors, contradictions, and equivocations in Marx's theoretical system is to be found in the entirely incompatible conceptual framework with the actual facts of economic life under capitalism (pp. 477–84, 603–13).

Marx viewed capital and accumulation of capital as “begetting” profits by a process of surplus value appropriation. By virtue of having monopolized the bulk of the means of production, capitalists are in the position to appropriate the total value created by workers. They are able to extract surplus value (profits) from the application of fresh labor power that creates the entire value of commodities by paying workers, the true producers, merely subsistence wages. Significantly, in developing this explanation of the origin of profit income, Marx builds upon the fundamental conceptual sequence as originally formulated by Adam Smith and accepted by all major economists since. Reisman shows the error in the conceptual sequence in the following way.

From the essentially correct fact that productive and purposive human labor is the primary means to transform nature-given resources into physical means to sustain and improve material conditions of human life and well-being, Marx, following Smith, impermissibly concludes that the wage income is the natural and primary income category of (manual) labor and that all other categories of income (profits, interest, dividends, rents) existing under capitalism are by necessity deductions from what naturally and rightfully should belong to the wage earners. And so, if it were not for the “appropriation of land and accumulation of stock” by a few, so Smith and Marx, the total value of products would exhaustibly be all wages and really belonged to the wage earners. The ascendancy of the marginal utility theory of value did not materially change this understanding. Reisman openly declares and provides a proof of his case that the Smith-Marx framework is actually fully in accord with the otherwise quite different positive theory of interest of Marx's strongest 19th century critic—Eugen von Böhm-Bawerk.

⁷Available as a free copy on the website of the Ludwig von Mises Institute, <http://mises.org/books/karlm Marx.pdf>

Böhm-Bawerk merely provided a strong critique of some aspects of Marx's theory, not the whole of it. The legacy of Smith and Marx on the subject of profits/interest and wages continued to live on totally unchallenged even in the writings of Marx's staunchest critics, including Mises, Hayek, and Rothbard.

What is wrong with Marx's conceptual and substantive description of capitalist economic reality? The basic error, begetting all other errors in the Marxian system, consists in the implicit equivocation between manual labor and wage *income*.

It should be obvious that merely to work and produce things is not the same as to work for money and *receive wages for the work performed*. The two pairs are brought into a definite relation only if there is someone willing and able to invest the necessary *money* funds as wage payments. Furthermore, the more capital is invested in form of wage payments and/or acquisition of capital goods the greater is the extent of the division of labor, the greater is the productivity of labor and thus the higher will be the standard of living, above all of the wage earners. In no way can profit be attributable to the exploitation of labor (let alone manual labor) by capital and capital accumulation. To the contrary, with respect to the process of (nominal and real) income formation, Marx attaches to the accumulation of capital a role which is exactly opposite to the actual one.

In absence of buying for the purpose of subsequently selling on the markets for outside-labor and capital goods, there is simply no physical basis for the division of labor, and its corollaries—the markets for labor and capital goods, to develop. And since productivity of labor and living conditions depend directly on a high and increasing degree of division of labor, (money) capital and capital goods are absolutely indispensable contributing elements. In the nexus of market exchange in a developed division of labor economic system, the extent of both money and real wages, Reisman shows persuasively, are crucially dependent on funds saved and productively invested, i.e. the amount of money capital invested, relative to sales revenues in the economic system as a whole. In making the point even more clear, it is perhaps best to quote Reisman himself:

Thus, in the precapitalist economy imagined by Smith and Marx, all income recipients in the process of production are workers. But the incomes of those workers are not wages. They are, in fact, *profits*. Indeed, *all* income earned in producing products for sale in the precapitalist economy is profit or "surplus-value"; no income earned in producing products for sale in such an economy is wages. For not only do the workers of a precapitalist economy earn product sales revenues

rather than wages, but also those workers have *zero* money costs of production to deduct from those sales revenues.

They have zero money costs precisely because they have not acted as capitalists. They have not bought anything in order to make possible their sales revenues, and thus they have no prior outlays of money to deduct as costs from their sales revenues. Having made no productive expenditures, they have no money costs... (p. 478)

Smith and Marx are wrong. Wages are not the primary form of income in production. Profits are. In order for wages to exist in the production of commodities for sale, it is first necessary that there *be capitalists*. The emergence of capitalists does not bring into existence the phenomenon of profit. Profit exists prior to their emergence. The emergence of capitalists brings into existence the phenomena of productive expenditure, wages, and money costs of production.

Accordingly, the profits that exist in a capitalist society are not a deduction from what was originally wages. On the contrary, the wages and the other money costs are a deduction from sales revenues—from what was originally all profit. The effect of capitalism is to create wages and to reduce the relative amount of profits. The more economically capitalistic the economy—the more the buying in order to sell relative to the sales revenues—the higher are wages relative to sales revenues, and the lower are profits relative to sales revenues.

Thus, capitalists do not impoverish wage earners, but make it possible for people to *be* wage earners. For they are responsible not for the phenomenon of profits, but for the phenomenon of wages. They are responsible for the very existence of wages in the production of products for sale. (p. 479)

It is therefore not an accident that in primitive non-capitalist societies of past and present, capital and capital accumulation are either negligibly low or absent entirely while the standard of living of those societies merely oscillates around stagnant levels.

Consistent with the analytical substance of his critique of exploitation theory, Reisman's model explains the observed strong correlation between low capital accumulation and low standard of living by the absence of the class of profit-seeking businessmen and capitalists. Their enormous productive contributions consist in creating the division of labor by organizing and managing business firms that continuously introduce new and improved products and services, in supplying capital funds that raise the monetary demand for labor (nominal wages) and the demand for capital goods, in striving to economize on human labor in industry after industry by replacing it with machinery, raising thereby the productivity of the unit of labor supply (real wages).

To a society consisting exclusively of self-employed farmers and artisans working with their own means of production not only the notion of a labor market is completely alien. Economically, what takes place is simply everybody producing whatever goods and services he can produce with the most primitive tools of production and his own labor. To the extent money is used at all, it serves merely to facilitate the trade with the consumers' goods only. No money outlays are used to buy capital goods or labor services to be subsequently employed in the production. Thus, for example, no raw leather or wooden tools are bought in order to employ them in the production of leather pants. In one sentence, *markets* for factors of production are non-existent. (Money) incomes earned in such an economy are all profits because there are no *money* costs to be deducted from sales revenues.

A self-employed farmer when he brought his crops to the market and exchanges them for money received sales revenues, not wages. Only to the extent that a portion of sales revenues is used for the purpose of paying outside labor, the income category of wage income is present. Wage payments, alongside expenditures for capital goods, are a cost factor to be subtracted from sales revenues. It is therefore absolutely erroneous to think of profits as being somehow a subtraction from wages. Profits are the difference between sales revenues and costs of production and their magnitude is positively and linearly proportional to the former and negatively to the latter.

In short, everything that serves to increase sales revenues tends to raise profits, and everything that serves to increase the outlays for factor of production tends to lower profits. If there are no investment outlays to pay wages or purchase capital goods, assuming fixed aggregate sales revenues, the rate of profit is infinite and the aggregate amount of profit equals the full (100 percent) volume of sales revenues, quite simply because capital invested, and consequently costs of production, is zero. At the same time, the extent of division of labor is rudimentary, productivity of labor and real wages are consequently very low. As a rule, high profits will be found in societies with low standard of living, while low profits and wages high in rapidly progressing economies.

In light of these considerations there is no escape from the conclusion that exploitation theory's description of the mechanics of the process and determinants of income formation and distribution under capitalism has the facts of economic reality exactly backwards.

On a number of important junctions, the reader must already have noticed the extreme originality of Reisman's system. Its freshness and unorthodoxy will strike one as even more remarkable once one begins to

realize that the system puts forward a tightly integrated description of all leading micro- and macroeconomic phenomena. As such, I see the system as consisting of several major blocks whose development is aided by a number of highly potent analytical techniques such as the assumption of *invariable money* (pp. 538–40) or Reisman's single-handedly developed system of national income accounting (pp. 699–709).

In the remainder of the review I will very briefly discuss only three of them.

There is first of all the highly original theory of profit/interest which Reisman calls the *Net-Consumption/Net-Investment Theory of Profit* (Chapter 16). The theory really serves as an analytical transmission belt connecting all other elements of his system into one unified whole.

In particular, on the basis of the *Net-Consumption/Net-Investment Theory of Profit* the second block—the extremely original and powerful theories of saving and capital accumulation are developed and successfully applied in the author's dynamic theory of economic progress (Chapter 17).

Significantly, Reisman's theory of saving stipulates that in the absence of a steadily growing money supply (invariable money assumption) net-saving/net-investment must disappear, implying a permanent steady-state capital-income ratio, for the reason that eventually net-saving out of income will bring about a "desired ratio of provision for the future relative to the present". (pp. 834–35) However, the constancy of capital-income ratio would hold only in terms of monetary aggregates while the volume and quality of the real capital stock, hence real income, can go on rising virtually indefinitely, provided the stock of real capital is employed efficiently and the economy's overall capacity to produce capital goods exceeds the ongoing depreciation of the capital stock. In this connection, the role of the technological progress in overcoming diminishing returns to scale of physical capital goods is allotted a particularly prominent role. The in national income statistics observed persistently positive net-saving/net-investment rates are explained by the rate of growth in the quantity of money. Furthermore, Reisman's theory of profit/interest in conjunction with his theory of saving sheds an important light on the precise nature of Solow-residual.

In Reisman's theory of saving alone I see nearly unlimited scope for extremely fruitful research.

The third major block is Reisman's *Productivity Theory of Wages* (Chapter 14). I have introduced some of its distinctive elements already in the critique of the exploitation theory. But theory's originality has much more in store for us. It describes the process of wages determination from an absolutely

original angle. Quite importantly, though close in name, it should not in any way be confused with the neoclassical as well as Austrian marginal theories of factor pricing because *Productivity Theory of Wages* describes the process of wage determination along very different lines, more in agreement with the logic of classical economics, though by no means entirely so.

There are so many absolutely revolutionary theoretical contributions that a major book alone would probably be required merely to document and explain them, let alone to develop further its major elements. All in one, in *Capitalism* we glimpse at the beginning of a new era in theoretical economics. Anyone wanting to be a part of it should immerse himself into the study of its magnificent content.