

## Civilizing capitalism: “good” and “bad” greed from the enlightenment to Thorstein Veblen (1857-1929)<sup>1</sup>

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*As we look over the country today we see two classes of people. The excessively rich and the abject poor, and between them is a gulf ever deepening, ever widening, and the ranks of the poor are continually being recruited from a third class, the well-to-do, which class is rapidly disappearing and being absorbed by the very poor. Milford Wriarson Howard (1862-1937), in *The American Plutocracy*, 1895.*

This paper argues for important similarities between today’s economic situation and the picture painted above by Milford Howard, a member of the US Senate at the time he wrote *The American Plutocracy*. This was the time, the 1880s and 1890s, when a combination of Manchester Liberalism – a logical extension of Ricardian economics – and Social Darwinism – promoted by the exceedingly influential UK philosopher Herbert Spencer – threatened completely to take over economic thought and policy on both sides of the Atlantic.

At the same time, the latter half of the 19<sup>th</sup> century was marred by financial crises and social unrest. The national cycles of boom and bust were not as globally synchronized as they later became, but they were frequent both in Europe and in the United States. Activist reformer Ida Tarbell probably exaggerated when she recalled that in the US “the eighties dripped with blood”, but a growing gulf between a small and opulent group of bankers and industrialists produced social unrest and bloody labour struggles. The panic on May 5, 1893 triggered the worst financial crisis in the US until then.

In economic theory, this increasing concentration of wealth and power that resulted from ostensibly “free market” activities caused a massive upheaval against classical economics in the late 19<sup>th</sup> century. In his three-volume *Main Currents in Modern Economics* (1971)<sup>2</sup> Ben Seligman expressively entitles the first volume, dedicated to this period, “The Revolt against Formalism”. This revolt was spearheaded under different labels – historicism, institutionalism, empiricism, social policy, religion, socialism, ethics – but all these movements were in practice directed against the two-pronged movement of Manchester Liberalism (similar to today’s neoliberalism) and Spencerian Darwinism. Ricardian formalism and social Darwinism decidedly lost this battle. In the US the 1890s saw the beginning anti-trust legislation and an increased awareness to social issues and a social justice which markets alone were obviously unable to deliver. Europe saw the growth of what was to become the welfare state, and the German *Verein für Sozialpolitik* (Association for Social Policy) pragmatically and patiently leading the way over a period of sixty years. Capitalism was tamed in the sense that predatory activities, excessive market power, and speculations were harnessed, while social problems were met by new policy institutions.

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<sup>1</sup> This paper is based on discussions in the volume *Thorstein Veblen: Economist for an Age of Crises*, Erik S. Reinert & Francesca Viano (eds.), London: Anthem (The Other Canon Series), 2012

<sup>2</sup> Ben B. Seligman, *Main Currents in Modern Economics. Economic Thought since 1870*, 3 vols., Chicago: Triangle Books, 1971 (a one-volume edition had been published in 1962 by The Free Press).

Three economics texts from the late 1890 – by Gustav Schmoller (Germany), Herbert Foxwell (UK), and Thorstein Veblen (US) – represent the revolt against formalism and the resulting taming of capitalism. Although their styles and agendas were different, they are important representatives of the alternative theory that solidified on both sides of the Atlantic during the 1890s. They created an alternative to what Gustav Schmoller called *the irrational twins*: Manchester Liberalism and communism. This 1890s generation laid the foundations for the Middle Way between communism and Manchester liberalism, for a regulated capitalism with decent economic distribution and after the 1930s – as long as this theory was kept in place – also without major financial crises.

The mainstream canonical account of the history of economic thought has come to overshadow the important radical and influential voices of Schmoller, Foxwell, and Veblen. Instead today's focus on this period is on the marginalists, a group of economists who chose to avoid studying issues with normative and political implications – but therefore also chose political irrelevance – and the neoclassical tradition starting with Alfred Marshall's *Principles of Economics* (1890). With marginalism and Marshall – particularly in the appendices to his *Principles* – economics was to develop into the new and even more sterile formalism. However, the revolting group of economists here mentioned helped shaping the incentive system of capitalism so that the interests of individual capitalists again were brought in line with the interests of society at large.

Starting in 1929, The Great Depression saw a rehash of the social and theoretical conflicts of the 1890s, but this time featuring a new generation of economists: Joseph Schumpeter in the German speaking and John Maynard Keynes in the English speaking world, both men born in 1883. However, the foundations of the science of controlling and civilizing industrial capitalism – the basic arguments against what today is called neoliberalism – had been laid in the preceding generation.

Now history is repeating itself, as usual with variations. Crises, then and now, necessarily bring with them a discussion of the role of self-interest and greed in capitalism.<sup>3</sup> Greed, or avarice, is one of the seven mortal sins of Christendom. However, since capitalism is based on self-interest, successful capitalism must separate the kind of self-interest which contributes to *wealth creation* from that which constitutes predatory *wealth extraction*.<sup>4</sup> In other words productive self-interest or *good greed* must be separated from *bad greed*. Neo-classical economics, however, contains no internal arguments against Gordon Gekko's *Greed is Good* in Oliver Stone's 1987 movie "Wall Street". The economics of the 1890s, however, had theories which provided the necessary separation, and it is time to re-discover them.

Thorstein Veblen's work was the one making the clearest separation between the human proclivities that produce – respectively – *good* and *bad* greed. I shall argue that Veblen re-invented wisdom and insights that had already been made during the Enlightenment, insights that need to be re-discovered. However, just as last time, these insights cannot be re-discovered without ridding economics of excessive neoclassical formalism which – through its

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<sup>3</sup> Many books have been published on the subject of greed recently. A historical overview is provided by David E.Y Sarna, *History of Greed, Financial Fraud from Tulip Mania to Bernie Madoff*, Hoboken: Wiley, 2010.

<sup>4</sup> A discussion of this and a fifty page bibliography on the issue are found in Erik S. Reinert and Arno Daastøl, *Production Capitalism vs. Financial Capitalism – Symbiosis and Parasitism. An Evolutionary Perspective and Bibliography*, The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics, No 36, 2011. Downloadable on <http://hum.ttu.ee/tg/>

inability to separate *good greed* from *bad greed* – provides dogmas which presently benefit wealth extraction at the expense of wealth creation.

### **1890s: three elements in the revolt against formalism**

Opposition to an overly formalistic science of economics would focus on three key aspects of the economics of David Ricardo (1817) which – if employed in practical policy – will distort policies in ways which, contrary to what the same theory claims, often create rents that distort the distribution of economic gains. We could call them Ricardo's three vices:

1. *Ricardo's assumption-based rather than an empirically based theory.* The belief that one could easily deduce policy conclusions directly from a highly abstract theoretical model leads the profession systemically to ignore important aspects of reality. This is the original *Ricardian Vice* as described by Schumpeter. Instead economic theory needed to be experience-based: built on observations of reality rather than on assumptions taken out of thin air. If “perfect competition” is assumed while oligopolies and monopolies are a normal state of affairs, policies based on the assumption of “perfect competition” will create rents to the companies that operate under oligopolies and monopolies.
2. *Ricardo's built-in defence of colonialism.* Establishing the theory of international trade on the barter of labour hours, void of any qualitative features, Ricardo created an economic theory where all economic activities became qualitatively alike: a stone-age technology was implicitly defined as equally conducive to economic welfare as industrial age technology. Ricardo made colonialism morally defensible.
3. *Ricardo's failure to distinguish the financial sector from real economy.* Although he did connect the quantity of money to inflation, Ricardo's economic system failed to distinguish between the monetary (financial) sphere of the economy and the real economy of goods and services.<sup>5</sup> This Ricardian foundation plays an important role in the present crisis. First, it makes it impossible to describe an economic world where the financial sector takes on a parasitic – rather than a supportive – relationship to the real economy of goods and non-financial services. Secondly, as a corollary to this, it opens up for the erroneous belief that a rapidly growing financial sector at the expense of the real economy is qualitatively no different from the growth of the industrial sector at the expense of the agricultural sector. And thirdly and more specifically – which is the main point of this paper – this Ricardian foundation makes it impossible to distinguish between making money in a way that increases the size of the economic pie (*good greed*) and making money in a way that reduces the size of the economic pie (*bad greed*).

The Ricardian vices and their neo-classical equivalents give rise to important economic rents. The failure to distinguish qualitatively between economic activities produced an excuse for colonialism, and made it possible for colonial powers to extract rents from the Third World. The failure to distinguish between the financial sector and the real economy – the failure to see that finance may become parasitic – makes it possible today for the financial sector to

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<sup>5</sup> Ricardo made his fortune in the financial economy, as a stockbroker and loan broker.

make huge profits from predation on the real economy. Ironically, mainstream economics which on the surface abhors rents – like those created by industrial policies – itself produces huge rents to the parasitic elements of capitalism. Formal Ricardian and neo-classical economics are in actual fact the rent-seekers' best friend. The ostensible non-normative and non-political mainstream theory as a matter of fact plays an important role as a de-facto ally of "the one per cent": mainstream economics plays the role of useful and well-paid collaborators. Just like financial crises, the unproductive rents collected do not exist in theory, they only exist in practice.

This paper, then, focuses on the third of these Ricardian vices, the one that is at the root of the present crisis of the West. But first a brief note on the three publications by the representative rebels of the 1890s: Herbert Foxwell (1849-1936), a Cambridge economist who was president of the Royal Economic Society and founded what are probably the two best collections of economics book, now at Harvard (Kress Collection) and the University of London (Goldsmiths' Collection). Gustav von Schmoller (1838-1917), Founder of the *Verein für Sozialpolitik* and later Rector of the University of Berlin, and the major US economist of this generation: Thorstein Bunde Veblen (1857-1929), the Norwegian-American economist who founded both evolutionary and institutional economics.

The first of the three publications is Gustav Schmoller's 1897 inaugural speech as Rector of the University of Berlin, which laments that "the human idealism of Adam Smith" had degenerated into "the hard mammonism of the Manchester School"<sup>6</sup> (i.e. today's neoliberalism) and where he decries the naiveté of both laissez-faire and communism as "twins of an ahistorical rationalism".<sup>7</sup> As already noted Schmoller decried what he called the two irrational twins: Manchester Liberalism and communism. Schmoller's typifies the views of the German Historical School, or – as they were called – the socialists of the chair (*Kathedersozialisten*).

The second work of revolt, two years later, is Cambridge economist Herbert Foxwell's 110-page introduction to a book by Anton Menger.<sup>8</sup> Foxwell also distances himself from both political utopias and – very importantly – holds David Ricardo's work responsible for the political ills to *both* the political right and the political left, i.e. for the ills of both of Schmoller's *irrational twins*. Foxwell's criticism of abstract Ricardian theory has a strong punch:

Ricardo, and still more those who popularised him, may stand as an example for all time of the extreme danger which may arise from the unscientific use of hypothesis and social speculations, from the failure to appreciate the limited application to actual affairs of highly artificial and arbitrary analysis.<sup>9</sup>

Thorstein Veblen's *The Theory of the Leisure Class* is a third element in this theoretical revolt of the late 1890s. It was published in the same year Foxwell published his anti-Ricardian treaty. Both Schmoller and Foxwell were, not surprisingly, favourably referred to by Veblen.<sup>10</sup>

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<sup>6</sup> On the Manchester School, see William D. Grampp, *The Manchester School of Economics*, Stanford: Stanford University Press, 1960.

<sup>7</sup> Gustav Schmoller, *Wechslende Theorien und faststehende Wahrheiten im Gebiete der Staats- und Socialwissenschaften und die heutige deutsche Volkswirtschaftslehre*, Berlin: W. Büxenstein, 1897; online: [www.othercanon.org](http://www.othercanon.org)

<sup>8</sup> Herbert Foxwell, introduction to Anton Menger, *The Right to the whole Produce of Labour*, London: Macmillan, 1899. Online: [www.othercanon.org](http://www.othercanon.org)

<sup>9</sup> Foxwell, *op.cit.*, p. xli.

<sup>10</sup> Thorstein Veblen, "Review: Gustav Schmoller, *Über einige Grundfragen der Socialpolitik und der Volkswirtschaftslehre*", *Journal of Political Economy* 6.3. (June 1898), 416–19. Foxwell's introduction to

When Veblen mocks Ricardian context-free and overly formalistic economics, he is essentially making the same point as Foxwell, but he uses a very different style:

A gang of Aleutian Islanders slashing about in the wrack and surf with rakes and magical incantations for the capture of shell-fish are held, in point of taxonomic reality, to be engaged in a feat of hedonistic equilibration in rent, wages, and interest.<sup>11</sup>

What was to become the new mainstream was also clearly influenced by the changing paradigm of the 1890s, towards a less abstract and more dynamic type of economics. When Alfred Marshall lists his influences in the introduction to his *Principles of Economics* (1890), he does not mention Smith and Ricardo. The two kinds of influences that have affected the book “more than any other”, says Marshall in the introduction to his *magnum opus*, are those of biology, as represented by the writings of Herbert Spencer, and “of history and philosophy, as represented by Hegel’s *Philosophy of History*”.<sup>12</sup> These were aspects later lost by Marshall’s neoclassical successors: the theory was more than ever before elevated into highly prestigious but sadly irrelevant levels of abstraction.

### **The enlightenment discovery and taming of private interest – from Bernard Mandeville to Pietro Verri.**

The writings of Bernard Mandeville (1670-1733) came as a shock to early 18<sup>th</sup> century Europe. His book *The Fable of the Bees; or Private Vices, Publick Benefits* (1724)<sup>13</sup> – of which a first volume was published in 1714 – opened up for individual self-interest as a main engine of growth inside an economic system of laissez-faire. Mandeville could be interpreted as claiming all greed is good greed. The ensuing events and debates in Europe – essentially lasting through the rest of the century – fine-tuned the limits of this laissez-faire, gradually leading to a system which in practice lined up the incentives for the private sector to coincide with what was in the interest of society at large: **private interest was let free only where it coincided with the public interests**. Private interest which was in conflict with the public interest was what I for short have labelled *bad greed*, and institutions and legislation were created in order to prevent such activities.

At the time Mandeville was accused of heresy, being a “zealot of infidelity”, of “subverting order and discipline in the Church” and of “recommending luxury, avarice, pride and all kind of vices as being necessary to public welfare”. Nevertheless, as the 18<sup>th</sup> century progressed, Mandeville’s basic message of the importance of self-interest came to be recognized. His message was simplified by an example provided by Adam Smith: It is not through the kindness of the baker that we get our daily bread, it is because the baker needs to make money.

The effect of Bernard Mandeville’s *The Fable of the Bees* was like that of a torch to a pile of dry wood. Mandeville’s claims that “private vices could become public virtues” – indeed the whole basis for Adam Smith and today’s mainstream – went totally against the previous idea of a society constructed on virtue, on the *virtù* of the Renaissance civic humanism. In 1757

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Menger is referred to by Veblen as “Menger’s admirable introduction” in *Essential Writings of Thorstein Veblen*, eds. Charles Camic and Geoffrey M. Hodgson, London: Routledge, 2011, p. 375.

<sup>11</sup> Thorstein Veblen, *The Place of Science in Modern Civilization*, New York: Huebsch, 1919, p. 193.

<sup>12</sup> Alfred Marshall, *Principles of Economics*, London: Macmillan, 1890.

<sup>13</sup> Bernard Mandeville, *The Fable of the Bees; or, Private Vices Public Benefits*, London: T. Ostell, 1806.

Erik Pontoppidan – Rector of the University of Copenhagen and the editor of Denmark-Norway's first economic journal – provides an example of the attempts at drawing demarcation lines in Mandeville's work between the self-interest which *promotes* the common weal and that which *destroys* the common weal:

I know how an English author of the work *The Fable of the Bees* can argue for lasciviousness and luxury: that it creates labour for many hands. This can apply to policy when foreigners buy more of the work than we do ourselves, when the raw materials are our own, and when the hands of our labourers are more than those who can be employed at the plough, at the flail<sup>14</sup>, and at the oars. I also know what has been replied to this writer, with good reason, that if his suggestions had been well founded, it would follow that a group of arsonists, to whom it occurred to set fire to all four corners of London, ought to be seen as the best of patriots, because they, more than anyone else, would do much for the trade and employment of many thousands of masons, carpenters and other artisans in the reconstruction of the town.<sup>15</sup>

The debate on luxury was a central to the Enlightenment, requiring a limitation similar to that between *good* and *bad* greed. Pontoppidan hints at the answer: luxury became accepted as long as it adds value to local raw materials and/or employs idle hands, and as long as it does not worsen the balance of payment. We must keep in mind that most nations at the time were far from the production-possibility frontier, had much underemployment, and balance of payment problems.

As the 18th century grew older, the fine-tuning of the limits of private interests – of greed – advanced. In his main work of 1771, Count Pietro Verri of Milan succinctly condensed the limits to Mandeville's theory in one brief sentence:

Because the private interest of each individual, ***when it coincides with the public interests***, is always the safest guarantor of public happiness.<sup>16</sup>

*Any and all* greed and self-interest is obviously not compatible with public interest, only the self-interest which increases rather than diminishes the size of the economic pie. This would be the *good* self-interest or greed. Today the financial sector shows us that it is as easy to make money ruining a country as by building it up, which would obviously be *bad* greed, one that does *not* coincide with the public interest. But since economic theory has lost society as an economic category – a fact famously restated by Margaret Thatcher – it has not been noticed that the same theory has lost the middle part of Verri's sentence: self-interest and greed is only good when it coincides with the public interest. In this way neo-classical economics has opened up for a Gordon Gekko-like theory where all greed is good.

What we could call *Verri's Rule* distinguishes the *good* greed which is in the public interest from the *bad* greed which is a predatory greed not in the public interest. Verri's Rule is reasonably clear, but not necessarily clear-cut in all applications. The kind of self-interests which produces innovations and goods and services increasing the size of the economic pie for all is a good kind of "greed". Henry Ford, for example, made money in a way which

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<sup>14</sup> Instrument used for threshing grain.

<sup>15</sup> *Danmark og Norges Oeconomiske Magazin*, Preface to Vol. 1, 1757.

<sup>16</sup> Pietro Verri, *Meditazioni sulla economia politica*, Genova: Ivone Gravier, 1771, p. 42, emphasis added.

revolutionized transportation and increased the size of the economic pie. The same positive effects for society cannot be found when George Soros brought down the British pound. Markets need arbitration which, it can be argued, is in the public interest. But actively inducing huge devaluations and speculative gains is something different from arbitration.

If we attempt to employ Verri's Rule to the 2012 election debate around Mitt Romney's economic activities in Bain Capital, this company's activities probably come out on both sides, both as good and bad greed. Leveraged buyouts may put troubled companies in working order, but these processes seem easily to degenerate into asset stripping and the overseas outsourcing of jobs, which – applying Verri's Rule – would be bad greed. Verri's Rule is clear and simple, and in my view useful, but of course not free of grey areas.

Pietro Verri's 1771 work shows that continental European economists had accepted and clarified Mandeville's basic message before Adam Smith, who is the one who tends to get the credit for this.

### **The French Revolution: an overdose of economic freedom leading to predatory greed**

Standard textbook economics normally traces its roots back to the times of feudalism, to the tradition of the French Physiocrats. The Physiocrats defined wealth as consisting only of the produce of agriculture; industry and services were deemed as "sterile" (after all we live only from food, right?). The emphasis of the Physiocrats on freedom of trade led to a situation we recognize today: much more money can be made through speculation in rising prices of items already produced (be it real estate, stocks, or food) than from producing new goods and services. Under the rule of Physiocracy in France more money could be made by taking wheat and flour out of Paris waiting for prices to rise, than from supplying bread to the inhabitants of Paris.<sup>17</sup> The *good greed* described in Adam Smith's example of the baker was crowded out by the *bad greed* of speculation. Freedom to speculate came into conflict with the freedom *from* hunger.

The excesses of the Physiocratic doctrine that dominated in France from the 1750s provided an important antidote to any extreme interpretation of Mandevillian freedoms. With the events leading up to the French Revolution, it became evident that some economic actors' *freedoms to* needed to be limited by other economic actors' *freedoms from*. Freedom of trade also brought with it the freedom to speculate, and this led to shortages of bread in Paris.

At the time the authorities, through their ideological beliefs, argued that – by definition – unlimited economic freedom would produce economic harmony. As one journal serenely put it in 1765: "The riots are not and cannot be the effect of real need because in a regime of liberty the dearth that the enraged minds fear, or feign to fear, is manifestly impossible".<sup>18</sup> In other words, if people are hungry, it must be something they imagine, because a system of freedom is automatically seen also to be a system of harmony. The models had become more real than reality itself, reflecting Ricardo's later view that if their doctrines don't tally with the facts that is just "so much worse for the facts"<sup>19</sup>. The parallels to today's economic theory should be reasonably clear.

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<sup>17</sup> For a discussion, see Steven L. Kaplan, *Bread, Politics, and Political Economy in the Reign of Louis XV*, 2<sup>nd</sup> edition, London: Anthem (The Other Canon Series), forthcoming 2013, p. 201.

<sup>18</sup> Kaplan, *op cit*, p. 201.

<sup>19</sup> John M. Ferguson, *Landmarks of Economic Thought*, New York: Longmans,

In spite of its theoretical impossibility, the speculation-induced scarcity of bread was real. In fact the economic debates of the day – between the Physiocrats who believed in unlimited economic freedom vs. the Anti-Physiocrats who believed capitalism needed regulation – is in a sense the prototype of an economic debate. The historical fact is that the Physiocrats lost all the battles, except the one in today's textbooks in economics: a standard history of economics starts with a mention of the Physiocrats as a preamble to the introduction of Adam Smith. In this sense, neo-classical economics is fictitious to its very roots: it proudly bases itself on a theory that lost all battles in practical economic policy. Indeed, the French Revolution broke out in 1789 on the day when news reached Paris that the last Anti-Physiocrat – Jacques Necker – had lost his job as French Minister of Finance.<sup>20</sup>

The political base of Physiocracy was found in the feudal landowners who benefitted from speculation, just as today's political basis of neoliberalism represents the same type of speculative interests. Today – without a gold standard and with an ability to create money out of thin air – the supporters of the “freedom to make money from speculation rather than from production” no longer rest with the feudal landlords, but with the financial sector. The same financial sector which today benefits greatly from an economic theory unable to distinguish the financial sector from the real economy. There is, then, an important qualitative difference between making money from the production of goods and services and profiting from changing prices for what has already been produced: between wealth creation and wealth extraction.

### **Thorstein Veblen's understanding of capitalism**

What are the defining characteristics of this capitalism which some – including myself – claim needs to be re-civilized? First of all, compared to earlier economic systems, capitalism is characterized by Polanyi's three fictitious commodities which had not been objects of purchase in previous economic systems: *land*, *labour*, and *money*.

Secondly, Werner Sombart adds to our understanding of the capitalist system when he defines its origins as the point where activities no longer ceased at the point when the immediate economic needs of the family had been met. Another characteristic of capitalism is, then, the *scale* of production and a large division of labour. Historically, capitalism was born in the Italian city states of the Renaissance in the spirit of *magna facere*, of doing great things, as in Lorenzo il Magnifico's Florence. Sombart also defines the institutional structure of capitalism as consisting of 1) the entrepreneur, 2) the modern state, and 3) the industrial system. This is a definition that also fits capitalism in the early Italian city states.

Leonardo da Vinci (1452-1519) – a prolific artist, engineer and inventor – is the prototype character at the birth of capitalism. But can his motivation only have been greed? A new motivation at the time of Leonardo was a religious gestalt-switch which took place under influence from the Eastern Church. Human beings were created in the image of God, and should therefore attempt to create as He had. Invention and innovation became a religious

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Green & Co. 1938, p. 142.

<sup>20</sup> Kaplan, *op. cit.*

duty.<sup>21</sup> *Innovations* – once a synonym for heresy for which Roger Bacon was punished in the 13th century – after the Renaissance became a goal for society, as in Francis Bacon's *Of Innovations* (1625).

Thorstein Veblen contributed to our understanding of capitalism by deconstructing the simplistic idea of self-interest into several facets, in a way compatible with its historical origins. In his *Theory of the Leisure Class* (1899), Veblen produced a classification of the spirits of capitalism which helps us understand the problems of today. While English economic theory in the tradition of Jeremy Bentham had constructed a passive *homo economicus*, a creature seeking pleasure and avoiding pain, Veblen – in the spirit of the Renaissance – thought that activity and initiative, not passivity, was the economic essence of Mankind. While other animals harvested, the essence of Man's economic activity was to Veblen *production*, not – as Adam Smith had claimed – *barter*.

To Veblen, society needed to be understood in its evolution over time, not in terms of statics or comparative statics. He saw this evolution being driven by human instincts and proclivities. On the productive side we have:

- 1) The *instinct of workmanship*, the desire to produce,
- 2) The *parental bent*, that human beings react to the fact that they are part of a larger society,
- 3) *Idle curiosity*, the not-for-profit desire to understand and therefore, in a positive sense, to control the world around us.
- 4) The *instinct of emulation*, of copying others with the intention of improving, be it in production, i.e. in technological development, or in consumption patterns, i.e. in conspicuous consumption.

These instincts were complemented by an instinct of *predation* – of *bad greed* – a desire to get something for nothing, to harvest where others have sown. Veblen's criticism of the predation instinct and the "vested interests" and their profit created from unproductive activities recall previous religious calls against usury. Usury was seen as an immoral act in which gold and silver received profits without having done any constructive work. Inanimate objects like gold and silver should not be allowed to procreate.

But Veblen was not a religious man, and his criticism did not confront the financial sector as such. Rather he attempted to separate capitalism into two distinct spheres of interest, those motivated by the instinct of workmanship and the other productive instincts (*the engineers*) making money from production, and the *businessmen* whose pecuniary gains came from predatory activities. Schumpeter's view of what motivates businessmen is in the spirit of the Renaissance and of Veblen, including his view that a motivation for early industrialists was to emulate the life-style of the feudal landlords.

Personally, as did at least one of Veblen's most influential students, I find it difficult to distinguish between engineers and businessmen in practical life. However, this does not mean that the distinction is not extremely useful, just that the demarcation line should probably be drawn elsewhere. At the root of today's financial crisis is a Veblenian mechanism of "vested interest", the desire of the financial sector to get something from nothing. First of all

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<sup>21</sup> Erik S. Reinert and Arno Daastøl, "Exploring the Genesis of Economic Innovations: The religious gestalt-switch and the duty to invent as preconditions for economic growth", *European Journal of Law and Economics*, Vol. 4, No. 2/3, 1997, pp. 233-283.

from speculative activities, from changing prices of goods which have already been produced, rather than from the production of new goods and services. The line between legitimate hedging of positions in the real economy and generating speculative bubbles may not be crystal clear, but it is there. Secondly, from the financial sector's ability to create money and liquidity far exceeding the ability of the real economy to invest this liquidity in a profitable way, thus creating unpayable debts. The excess liquidity created will accumulate as assets in the financial sector, and as liabilities in the real economy.

In practice central banks have not only been printing money, they have simultaneously been printing debt, the predatory collection of which represents an extreme case of *bad greed*. Greece was the first country to be driven into poverty by this mechanism. Bankruptcy and default has always been crucial elements in capitalism, and European nations must now be allowed to default like Latin American countries frequently have for over a century.

Capitalism may function well when the interest of the capitalist class is in line with the interests of society at large. When capitalists make money on new technology and production (based on Veblen's instinct of workmanship), they make money through *good greed* that automatically increases the size of the economic pie and therefore contributes to the common weal. A major achievement of Enlightenment economics, on which I argue Veblen builds, was to separate the economic activities where the vested interests contributed to the common good – where wealth-production was a by-product of self-interest and greed – and where greed produced no such beneficial effects.

In certain periods – those not dominated by Manchester liberalism or neoliberalism – it has been obvious that private interests – greed - were not always in perfect harmony in a market economy. The role of the legislator was seen as creating the policies that made sure individual interests coincided with the public ones. The role of the 1933 Glass-Steagall Act had precisely been to enforce this Enlightenment vision of the economy, to make sure that the interests which the financial sector could legally pursue stayed in line with the interests of society at large. As it now is, after the Glass-Steagall Act was abolished, heaps of money can be made by destroying economies – as we see in Greece – rather than by building them.

It is normal that capital floods to the newest and most profitable industries that display the highest rate of technical change and growth, be it Carnegie's steel mills, Ford's assembly lines or Bill Gates and his Microsoft. Capitalism collapses, on the other hand, when money flows to the financial sector per se, as if finance were an industry on par with steel, cars, or software. Thus, the fundamental flaw behind today's global situation is the failure to distinguish sufficiently between the real economy and the financial economy (see Fig. 1 below). This clear distinction was once understood – not only in Islamic economics as today – but all along the political axis from Marx and Lenin on the left, to social democrat Rudolf Hilferding – a Jew who was killed by the Gestapo – to the conservatives Schumpeter and Keynes, all the way to Hitler's economists on the far right. The German distinction between *schaffendes Kapital* (creative capital) and *raffendes Kapital* (roughly: capital which grabs existing wealth) is a useful parallel to *good* and *bad* greed, but unfortunately it was created by persons too close to fascism.

As Karl Polanyi points out, what communism, fascism and the New Deal had in common was a distrust of *laissez faire*. This included an understanding of the need to control the financial sector. Of the three ideologies that aimed at controlling the financial sector, it should be pretty obvious which one to choose: we need to recreate policies in the spirit of the New Deal. In a

sense the West – and Europe in particular – has not faced the task of a necessary clean-up of its ideological chamber of horrors from the 1930s as these ideologies related to the relationship between the financial sector and the real economy. For decades a separation of the financial sector – a mere mention of *Hochfinanz* or High Finance – risked being labelled as anti-Semitic, while it could just as well have been labelled communist or Rooseveltian. The political incorrectness that has surrounded the discussion of high finance is one reason why financial crises – once understood along the whole political spectrum – are so poorly understood today. In a strange way, the horrors of Holocaust have acted to deter and delay our understanding of the role played by the financial sector today.

A necessary ingredient in today's economic drama is also how the way in which economics was mathematized has contributed to the increasing dominance of Wall Street over the productive sectors. A failure to distinguish the financial economy other than as a mirror image of the real economy has made it impossible to formalize key basic insights about the role of the financial sector. Such insights only come with any analysis made from a book-keeping point of view – e.g. though approaches like those of Hyman Minsky – where it becomes obvious that the growth of assets in the financial sector will tend to accumulate as liabilities in the balance sheet of the real economy. If excessive debts are not cancelled, the real economy enters into a situation of debt peonage to the financial sector.<sup>22</sup>

The transfer of income and assets from the real economy to the financial economy is the most important long-term effect of the bad greed that is allowed to operate in this financial crisis. If these imbalances are not addressed by making big investments in the real economy, any recovery – however weak – will be driven by demand from the financial sector, and the losses in the real economy of the West may be permanent. This is now what is happening in the US and in Europe.

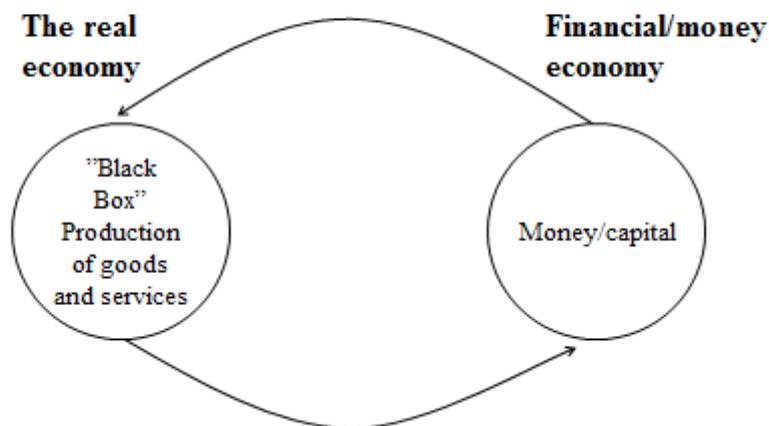
Financial crises are basically produced by a mismatch between the real sector of the economy and the financial sector, illustrated below.

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<sup>22</sup> For a discussion see my “Mechanisms of Financial Crises in Growth and Collapse: Hammurabi, Schumpeter, Perez, and Minsky”, in *Jornal Ekonomi Malaysia*, No. 46 (1) (2012), pp. 85-100, and *The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics*, No 39, 2012. Downloadable on <http://hum.ttu.ee/tg/>

**Figure 1.** The real economy vs. the financial economy

## The Circular Flow of Economics



Understanding financial crises requires a terminology that distinguishes the financial economy from the real economy. The financial economy consists of what Schumpeter called *Rechenpfennige*, or accounting units. In Veblen's terminology, this is the sector that bases its activities on pecuniary gain. The real economy consists of the production of goods and services, Schumpeter's *Güterwelt*, populated by people who in Veblen's terminology are engaged in material production based on the instinct of workmanship and a parental bend (an understanding of being part of society), including, of course, the engineers.

In times when capitalism functions well, the financial sector and the real economy live in a kind of symbiosis; they support each other. The financial sector functions as scaffolding to the real economy or, as Keynes put it, as a "bridge in time". During times of crisis the financial sector takes on a speculative life of its own and becomes a parasite weakening the real economy. As the speculative bubble grows, what was once rational (investing in new technology) gradually becomes irrational (investing in pyramid games)<sup>23</sup>. The right hand circle in Fig. 1 grows as a malignant tumour and feeds on the real economy in a parasitic way, decreasing wages and shrinking whole economies, as Greece experiences at the moment.

But bad greed can also exist inside the real economy. As Veblen argued, sabotage is sometimes part and parcel of business strategy. Reading Veblen on this in the 1970s sounded like a strange proposition, but when it was proven that ENRON had sabotaged the California electricity supply in early 2001 in order to have a price hike approved it became obvious that Veblen had been right. This was sabotage and *bad greed*. Indeed it seems that capitalism alternates between periods of relative virtue – as the decades following WW II – and periods of frontier capitalism, when all tricks are allowed, as during the 1890s and again now.

<sup>23</sup> That is, irrational from the point of view of society, but still rational to the individual speculator as long as the bad greed incentive system is in place.

The 1940 movie *Edison - The Man* – starring Spencer Tracy – gives us the story of how Thomas Edison (1847-1931) and his light bulb was sabotaged by the operators of gas lights for street lightening. But later Edison himself stood in the way of technological progress. Having invested heavily in direct current (DC) Edison fought the superior technology of alternating current (AC) pioneered by his former employee Nikola Tesla (1856-1943). AC is what we now use because of its high voltage and ability to be transported long distances.

Thorstein Veblen's term *vested interests* describes a financial stake in a particular outcome. The young inventor Edison fought for his light-bulb against the vested interests of the businessmen who owned the gas light operations. Later, when Edison himself had become a businessman, he fought even more vigorously than the gas light people had against a new and better technology: the alternating current of Nikola Tesla. In other words, engineers have vested interests – promoting innovations – which differ from those of businessmen – the protection of their vested interests. Adding to Veblen's terminology, engineers represent good greed and business represents bad greed.

During his lifetime Thomas Alva Edison, then, played both sides –representing both good and bad greed – in the evolution of electricity. The young and old Edison represent the two different forces – the hero and the villain / good and bad greed respectively – in the history of electric energy, in what was called “War of the Currents”.

Presently a similar fight is taking place in the US energy sector. A massive campaign is organized against subsidies for renewable energy by people with vested interests in old technology, particularly coal. The conflict peaked with the so-called Solyndra Scandal. Solyndra was a company founded in California in 2005 in order to produce solar panels, and it received a Federal Loan of 535 million dollars. This money was lost, and caused a huge scandal in the US, helped by a six million dollar ad campaign from the Koch Brothers to blow the loss totally out of proportion. A sober look at the situation reveals that the amount lost corresponds to 6.7 hours, or 0.28 days, of the annual US defense budget. This is not a large amount of money to invest in creating a steeper learning curve for clean energy. *Bad greed* – interested in prolonging the life of polluting technologies – sabotages *good greed* wanting to make money on clean energy. If we re-introduce the public interest as an economic category, it makes sense to distinguish *good greed* from *bad greed*.

Thorstein Veblen generalized this conflict between businessmen and engineers by saying that human society would always involve conflict between existing norms with vested interests, and new norms developed out of an innate human tendency to discover and invent, based on improving our understanding of the physical world in which we exist. “Idle curiosity” and “the instinct of workmanship” are positive proclivities of man (leading to good greed businesses) that continuously would be fighting the pecuniary interests of those with a vested interest in status quo (bad greed businesses).

### **1989: how the death of one of the irrational twins brought forth the monster in the other**

The same worry of a disappearing middle class expressed in the 1895 book which heads this paper e had already been voiced by Gustav Schmoller when – at the 1872 founding meeting of the *Verein für Sozialpolitik* – he feared that “society was becoming like a ladder where all the middle steps have disappeared. There is only hold at the very top and at the bottom”. During the same meeting, Schmoller shows that the arguments at the time were similar to

those which used to be voiced by the Physiocrats and again by today's neoliberals: if we just get the last vestiges of control out of the way and let the market rule alone, harmony will be established.

The deep cleavage in our society separating entrepreneurs and workers, owning and not owning classes, represents a threat of a social revolution. This threat has drawn closer. In wide circles there have been serious doubts whether the economic doctrines which dominate on today's market – and which were expressed at the Economic Congress – forever will keep their dominance. Will the introduction of the free right to carry on business (*Gewerbefreiheit*) and the elimination of all mediaeval legislation on guilds really create the perfect economic conditions that the hotheads (*Heißsporne*) of that tradition predict? <sup>24</sup>

Instead of the market mechanism creating harmony, then as now we are increasingly experiencing what I have labelled *post-industrial feudalism*, a society economically controlled by a small per cent of the population (“the one per cent”) based on the control of a key factor of production. Today this is based on the control of capital rather than – as in classical feudalism – on the control of land.

As we have seen, in 1897 Schmoller – then Rector at the University of Berlin – had decried both Manchester Liberalism, today's neoliberalism, and communism as “twins of an ahistorical rationalism”. When the demise of communism, represented by the 1989 fall of the Berlin Wall, marked the death of one of these two ahistorical twins, one could have expected that experience-based rationalism – what Schmoller, Foxwell, and Veblen had stood for – could declare a resounding victory. That did not happen.

In fact the exact opposite happened. The fall of the Berlin Wall was followed by an unprecedented triumphalism of the other irrational twin: of a belief that unfettered markets would create economic harmony and even represent “the end of history”. In the 1990s, the forces that the *Revolt of the 1890s* had managed to stop – almost fact-free and static economics coupled with social Darwinism in the tradition of Herbert Spencer – virtually became the only game in town.

For all its irrationality, for more than one hundred years communism had provided both a benchmarking tool and a credible threat that civilized and humanized capitalist economies. A Galbraithian balance of countervailing powers – big business, big labour, and big government – had created generalized welfare in the West, on both sides of the Atlantic. Now – in the name of the market – big labour and big government were dismantled. Checks and balances, once so cherished in the United States, were to a large extent gone.

Also in the US post-WW II interest in human rights had to some extent turned to something resembling a war against these same rights, now relabelled as *entitlements*. In his infamous 47 per cent speech, Mitt Romney singled out those “who believe that government has a responsibility to care for them, who believe that they are entitled to health care, to food, to housing, to you name it. That that's an entitlement.” At the same time the United Nations' Rapporteur for the Right to Food, Olivier De Schutter, continues to work according to the principle that food is a human right.

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<sup>24</sup> Verein für Socialpolitik, *Verhandlungen der Eisenacher Versammlung zur Besprechung der Socialen Frage am 6. und 7. October 1872*. Leipzig: Duncker & Humblot, 1873, p. 5.

Again, the Ricardian blind spots of economic theory were used for rent-seeking in an unprecedented way. Monopolies were privatized in the name of “competition” and “free markets”. Assumptions of “perfect competition” in economic models blinded people to a reality of massive accumulation of market power, and a failure to distinguish the financial economy from the real economy sheltered a predatory financial sector from scrutiny by mainstream economics and therefore also from politicians. As the irrelevant assumptions of neo-classical economics increasingly came to pass for reality itself, massive assumption-based rents could be harvested though *bad greed*: self-interest which does not increase the size of the economic pie.

As with the situation leading up to the French Revolution, it is reasonably clear that the present crisis is a result of *excessive freedom*. The freedom of trade so cherished by the Physiocrats and their landowning benefactors made it more profitable to move grain and flour out of Paris in order to wait for prices to go up, than to bake bread for the citizens of Paris. The result was a shortage of bread which was the main cause of the French Revolution.

Today the financial sector enjoys the freedom to create virtually as much money as it wishes, freedom to loan the money to the nations and the individuals it wishes, and freedom to send the bill to nation-states and their tax-payers when debtors do not pay. Like in pre-revolutionary Paris, more money is made from speculative activities that do not increase the size of the pie – from *bad greed* – than from the production of goods and services, emanating from Veblenian proclivities: the instinct of workmanship and from the idle curiosity of which any innovation has an important element. Profit-making is normally a necessary element in the production of goods and services in a market economy, but by reducing human motivation to a hedonistic activity neo-classical economics fails to distinguish between *good* and *bad* versions of profit-making and greed.

As the West now faces multiple crises, the most immediately serious one is financial predation which rapidly shrinks the real economies in the European periphery. Italy and Spain are on track to become the next Greece. The medicine applied to satisfy the financial sector – i.e. austerity – in practice amounts to an attempt to massively reduce purchasing power, which sends the real economy into a cumulative spiral of decreasing wages, decreasing tax income, decreasing investments and – as a result of the falling cost of labour – decreasing incentives for labour-saving innovations. I find myself agreeing with Michael Hudson<sup>25</sup> that the only solution to the present problems of the West is some form of debt cancellation: the huge and unpayable debts – their own assets – that the financial sector has been allowed to create out of thin air must also be allowed to disappear into thin air.

At the moment *bad greed* – greed which decreases the size of the real economy – dominates in the West, further weakening its economic position vis-à-vis Asia. Just as it was first done during the Enlightenment, and later in the 1890s by Thorstein Veblen and his contemporaries, “greed” which leads to innovation and increased productivity again needs to be separated from predatory greed which, rather than create value, extracts value from national economies. As already mentioned, in his 1897 speech Gustav Schmoller lamented that “the human idealism of Adam Smith” had degenerated into “the hard mammonism of the Manchester School”<sup>26</sup>. The revolt of the 1890s reversed this trend and civilized capitalism. But now the

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<sup>25</sup> Michael Hudson, *The Bubble and Beyond. Fictitious Capital, Debt Deflation and Global Crisis*, Dresden: ISLET, 2012.

<sup>26</sup> Gustav Schmoller, 1897, *op. cit.*, online: [www.othercanon.org](http://www.othercanon.org)

same thing has happened again: humanism has been converted into neoliberal mammonism. This can be reversed again, but only by recreating the large diversity of economic approaches of the 1890s: historical, evolutionary, institutional, and ethical.

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