

CAPITALISM, SOCIALISM AND CALCULATION

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The merits and demerits of what we call 'capitalism' have been a source of much attention since Adam Smith wrote his seminal treatise on the salutary effects of free commerce and before. We consider the criticisms of the capitalist system as stated most prominently by Karl Marx, and we evaluate Marx's proposed solution to the evils of capitalism – specifically, socialism. We also explore the contributions of Ludwig von Mises and Friedrich Hayek to the debate about whether Marx's proposed alternative was really an alternative. Mises and Hayek provide powerful critiques of Marx's socialist vision by addressing the problem of economic calculation and the inability of central authorities to acquire knowledge diffused and distributed across an entire society. We question whether Marx offered a solution and then consider more recent attacks on capitalism and its alleged destruction of cultural capital. The theoretical contributions of Mises and Hayek are supported by recent empirical contributions suggesting that liberal political economy is robust.

Keywords: Capitalism, socialism, Smith, Hayek, Marx, culture.

Introduction

The debate over centralised or decentralised organisation of human affairs came to a head in the twentieth century. With the fall of the USSR, a renewed critique of liberal capitalism maintains that while it can line our pockets with the world's riches, capitalism leaves us culturally, intellectually, morally and spiritually impoverished. These criticisms assume that there is a viable alternative; the contributions of Mises and Hayek to the theory of economic calculation suggest that there is not.

We consider here some of the contributions made by 'system-builders' in economics as they relate to capitalism and socialism: Adam Smith, Karl Marx, Ludwig von Mises and F. A. Hayek. The key texts highlighting the differences between capitalism and socialism include Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*, Karl Marx and Friedrich Engels's *Communist Manifesto*, and the criticisms of socialism offered by Ludwig von Mises in his essay 'Economic Calculation in the Socialist Commonwealth' and Friedrich Hayek in his essay 'The Use of Knowledge in Society'. In light of recent empirical contributions on the effects of Wal-Mart's

diffusion and Deirdre McCloskey's ongoing study of what she calls 'The Bourgeois Era', we conclude with Boettke and Leeson (2004) that the Misesian and Hayekian tradition produces a robust liberal political economy.

Capitalism and socialism in *The Wealth of Nations* and *The Communist Manifesto*

The exact definitions of the terms remain contested, but a common distinction between 'capitalism' and 'socialism' is based on the differences in ownership arrangements: capitalism is defined by private property rights and voluntary exchange; socialism by the collective ownership of the means of production (which the state then manages).¹

The harmony of interests in a free society received one of its most important defences in 1776, when Adam Smith launched *An Inquiry into the Nature and Causes of the Wealth of Nations* (Smith, 1776 [1982]). In it, he addressed the roles that the division of labour, competition, capital accumulation and, most importantly, private property rights play in creating a functioning and prosperous economy. It is the division of labour, Smith argued, that serves as the foundation of the

commercial society because it allows for unparalleled increases in the productive capacities of labour. Specialisation moved us from a hunting and gathering system toward agriculture and industry by saving our time, encouraging us to generate better technology and encouraging learning-by-doing.²

Smith offered an important insight into the workings of a system in which knowledge of others' goals, wants, desires and merits is incomplete. We induce people to expend effort on our behalf by offering to make their lives more agreeable. In contrast to the Marxian 'anarchy of production', private property rights are necessary if people's interactions are going to generate order rather than chaos. If the fruits of one's effort can be expropriated by violence, one's incentive to supply effort weakens. Without private property (and therefore without prices, profits and losses), the degree to which human interactions generate order is limited. Complex society is limited by the extent of the market.

Drawing on a tradition that includes British political economy, German philosophy and French socialism, Marx and Engels develop a critique of capitalism that is rooted in a critique of private property rights.³ The central theme of the *Communist Manifesto* is explicitly clear: 'the theory of the Communists may be summed up in the single sentence: Abolition of private property.' Over time Marx's work would grow increasingly sophisticated, but this would remain essential to his system (Sowell, 1985).

Once able to eliminate private property, people would move into the final stage of social order (namely, communism) which would result in super-abundance and the elevation of humanity. Previous social orders ended through 'class struggles'. Marx claimed that capitalism would fall as the result of disparities in wealth and rights between the propertied and the property-less. Theoretically, socialism would eliminate inequality by eliminating private property, which was the source of inequality. Marx and Engels are clear on their goals, but they fail to establish a positive link between the eradication of private property and prosperity.

In *The Communist Manifesto* and the essays in *The Economic and Philosophic Manuscripts of 1844*, Marx's analysis of commercial society relies less on economic theory and more on perceived social injustice. In a posthumously published essay, 'Estranged Labour', Marx begins with what he calls 'an actual economic fact': 'The worker becomes poorer the more wealth he produces, the more his production increases in power and extent. The worker becomes an ever cheaper commodity the more commodities he produces' (Marx, 1844 [2000]). According to Marx, wages will always move toward subsistence.⁴

Marx's point in his early writings was that the returns from factors of production go almost entirely to the capitalist employers (it was a claim he and his followers would later modify in response to mounting evidence). 'Estranged Labour' goes on to explain how a worker is alienated from the product of his labour. Private property rights imply that labourers, because they own only their labour and must exchange it as a commodity, are alienated from their own productive output. This puts the worker at the mercy of the capitalist: the worker's humanity is debased by private property and the capitalist mode of production.

The worker's alienation was the social problem capitalism produced. To paraphrase Ekelund and Hebert (2007, p. 248), Marx held that the essence of alienation was the reduction of all human relationships to the 'mutual swindling and mutual plundering', in Marx's phrase, of market exchange. Because labourers own only their own labour and not the fruits of those labours, their labour comes back to confront them in an alien form as commodities (Marx, 1844 [2000]). The division of labour means that skills can be rendered worthless more easily by new methods of production. Because these workers have little or no capital, they are unable to compete on any level with the entrenched capitalists. They become 'slaves of the bourgeois class' and must accept whatever wage rate the capitalists offer (Marx and Engels, 1848 [2004]). Capital will be increasingly concentrated in the hands of a small class of capitalists; this will result in the impoverishment and, ultimately, revolution of the proletariat. Using a centralised state, revolutionaries will abolish private property rights and usher in a new era of material and spiritual prosperity (ibid.). Communism would be the 'transcendence of human self-alienation'; the communist programme was a philosophy of 'positive humanism' whereby people would be able to produce free from the shackles of 'the drive to accumulate property' (Tucker, 1978, p. xxv).⁵

Economic laws are not laws at all, according to Marx, but are historically context-dependent. They change with each new historical epoch. In his introduction to the first volume of *Capital*, Ernst Mandel (1990 [1976], p. 12) makes this point explicitly:

'An economic theory based upon the historical relativity of every economic system, its strict limitation in time, tactlessly reminds Messrs the capitalists, their hangers-on and their apologists that capitalism itself is a product of history. It will perish in due course as it once was born. A new form of economic organisation will then take the place of the capitalist one: it will function according to other laws than those which govern the capitalist economy.'

Calculation, co-ordination and co-operation

It was in the intellectual climate of European Marxism – the historicism of the German Historical School, specifically – that Mises wrote. The socialist viewpoint was that the abolition of private property would usher in the end of scarcity. Future scholars would offer confusing interpretations of the socialist claim.⁶ Mises was not responding to the socialists' claim that it was possible to have an organised society without all interactions being mediated by prices. Rather, it was that the abolition of private property would make us much wealthier if it did not abolish scarcity altogether.

In his 1920 essay 'Economic Calculation in the Socialist Commonwealth', Mises attempts to discover exactly how such a society will function and in so doing provides a rigorous (and devastating) critique of socialism. He starts by assuming that the socialist state has perfect information about preferences and can choose how to distribute consumption goods. It is possible that these people delay immediate consumption, accumulate small stocks of capital and barter. However, this would only be true of consumption goods; production goods are exclusively communal because 'they are an inalienable

property of the community' (Mises, 1920 [1990], p. 5). Trade in this system would be possible, but it would be limited to consumption goods.

Because factors of production are commonly owned, they are not traded. Therefore, prices do not emerge (Mises, 1920 [1990], p. 6). The key to economic calculation is the ability to appraise and evaluate what is being given up in any particular course of action (Mises, 1990, p. 225). Without prices for factors of production, there can be no economic calculation (Mises, 1920 [1990], p. 18). This means that it is impossible to determine whether the production processes currently employed are more profitable than others. The socialist state, therefore, cannot know whether it is producing its output at the lowest cost and cannot identify whether resources are being used wisely or whether they are being wasted. To paraphrase Mises, there is no way that the socialist planners can tell us whether we are satisfying society's most urgently-felt wants.

Hayek granted the socialists the assumption that economic calculation might be feasible if by 'economic calculation' we meant 'solving systems of equations', but then noted that the economic problem is not one of simple calculation. In his 1945 article 'The Use of Knowledge in Society', Hayek shows that the fundamental problem any economic order faces 'is a problem of the utilization of knowledge not given to anyone in its totality' (Hayek, 1945, p. 520). To put it another way, economic structures must find a way to 'secure the best use of resources known by any member of society, for ends whose relative importance only these individuals know' (Hayek, 1945, p. 520). Therefore, even if rational economic calculation is possible when factors of production are commonly owned, the economic problem is still one that can only be solved by private ownership of the means of production.

Hayek focuses on 'knowledge of the particular circumstances of time and place' (Hayek, 1945, p. 521). This knowledge is composed of tacit knowledge (which is knowledge that is wholly or partially inexplicable, such as the knowledge employed by one's nervous system when he or she walks across a room) and local knowledge (which is information about a specific location in a specific time, such as knowledge about traffic patterns in Memphis during rush hour). Planners external to the individual cannot know the former, whereas planners external to a particular region cannot know the latter. Hayek further remarks that diffused knowledge 'is knowledge of the kind which by its nature cannot enter into statistics and therefore cannot be conveyed to any central authority in statistical form' (Hayek, 1945, p. 524). And even if diffused knowledge could be measured, collected and transported to a central authority, it would be impossible for that central board to analyse the information and provide feedback about production line changes necessary for improvement. Parameters change rapidly. There simply would not be enough time for any central planner to continually adjust the plan to changing wants, ideas, cultures, institutions and organisations.

Socialism cannot solve Hayek's fundamental problem. Capitalism, which generates prices, can. It is not perfect, but the market is able to transmit large amounts of diffused knowledge to individuals who seek only to improve their own well-being. The individual consumer hardly needs to know

what happens anywhere in the world that might affect his decision-making. He does not need to know why certain goods are more available than others are or how difficult the factors of production were to acquire. His only concern is '*how much more or less* difficult to procure' some things are compared with others (Hayek, 1945, p. 525). Though imperfect, prices will address his concern and the result is a large number of individuals engaging in transactions without having to repeatedly turn to a third party and ask if their trade is 'fair'.

Robust (liberal) political economy and the shifting critique of capitalism⁸

The essential critique of capitalism has shifted, and instead of leading to widespread poverty capitalism is now impugned because it increases our material wealth at the expense of other virtues (McCloskey, 2006). The power of the Misesian and Hayekian critique of socialism specifically and interventionism more generally is that it demonstrates the impossibility of economic calculation even under the best assumptions about the intelligence and benevolence of the planners (Boettke and Leeson, 2004, p. 107). The essence of a robust framework is that it withstands the sharp critiques that constitute worst-case scenarios. Ritenour (1998) argues that 'the "cultural" critique of capitalism' holds that government must save us from the destruction of the culture. Playwright Edward Albee, for example, referred to what he called 'the killing hand of commerce' (Albee, 2007). Benjamin Barber (1996) argued that modern commercial society hollowed us out culturally.⁹ As Boettke and Leeson (2004, p. 105) put it, 'precisely because the classicals assumed the best-case scenario for the State and the worst-case scenario for the market and were able to show that imperfect markets achieve the same results as perfect government they were able to demonstrate the robustness of liberal political economy'.

The policy implications are apparent. Mises demonstrated pure socialism is impossible. But the existence of pure capitalism is unlikely; there will almost certainly always be some form of state power. As such, all economies exist on a continuum with varying degrees of socialistic and capitalistic tendencies. With respect to the selection of economic institutions, Mises' argument has an important implication: 'Every step that takes us away from private ownership of the means of production and from the use of money also takes us away from rational economics' (Mises, 1990 [1920], p. 12).

As Mises and Hayek argue, it would not matter if the state were filled with the smartest, most scientific and most virtuous people in the world. Given the constraints on human knowledge and limitations of time, it is not possible for a centralised authority to know if it is utilising the most effective methods of production and creating value. Even if a government knew the most effective way of coercing people, at best the policy would force people to make the trades they would not make without enforcement. Because it is highly implausible that a government would be able to do even this, it shows that government intervention will almost certainly destroy value.

Private property rights are also necessary if the concepts of 'capital' and 'income' are to have meaning. Mises (2006, pp. 65, 66) separates the definition of 'capital' from the definition

of 'capital goods'. A 'capital good' is a physical good that exists in an intermediate stage between the initiation of a production process and final consumption. 'Capital' represents the valuation of a firm's capital stock. It is only when the rights to capital goods are traded in markets that prices can be established and that capital stocks can be valued. The appraisal that takes place on the market tells the capitalist whether his stock of capital has been augmented or consumed.

Appraisal, valuation, and (ultimately) investment, saving and calculation can only take place when the means of production are privately owned. Here is Mises (2006, p. 66): 'The various physical and external factors of production cannot be compared in any other way than from the point of view of the services they render to men, calculated in terms of money.'

The 'killing hand of commerce', to use Edward Albee's phrase, is supposed to be manifested in the way it shifts our priorities toward materialism and away from higher, nobler and more spiritual pursuits. This claim is inconsistent with the evidence, however. The thrust of the research agenda being pursued by McCloskey (2006, 2010) is to explain how and why virtue and prosperity are complements and self-reinforcing inputs, and McCloskey's historical narrative receives some modern empirical support in the context of Wal-Mart's effects on society (Carden *et al.*, 2009a, 2009b; Carden and Courtemanche, 2009; Courtemanche and Carden 2011).

Wal-Mart's new 'Save Money, Live Better' motto reflects the classical view that by accumulating capital, we are able to increase future prosperity. Critics claim that Wal-Mart may be able to offer lower prices, but the consequences of doing so include the depression of workers' wages and benefits, reductions in social capital and the elimination of small businesses (among other things). After examining the relationship between the per capita number of Wal-Mart stores and various leisure activities, Carden and Courtemanche (2009) found that Wal-Mart entry corresponds to an increase in the participation in activities that utilise goods that can be bought at Wal-Mart (such as playing tennis or golf). Some evidence was found of a decrease in participation for activities that are unrelated to Wal-Mart; however, no decrease – and maybe an increase – in participation was found for some cultural activities (specifically visiting an art museum or classical music concert). Similarly, after measuring the effect of Wal-Mart on participation of several proxy variables for social capital (such as club membership, sports playing and dinner party attendance), Carden *et al.* (2009a) found that Wal-Mart had no significant effect on most of the proxies considered and no robust effect overall.

Conservative and liberal critics often accuse Wal-Mart of promoting values on the opposite side of the political spectrum. Conservative critics opposed its participation in the National Gay and Lesbian Chamber of Commerce; liberal critics claim it squelches artistic expression. Carden *et al.* (2009b) regressed the changes in an array of social values of a population over time against the prevalence of Wal-Mart in a given area and found that Wal-Mart had no statistically significant effect on nearly all of the measures of values.

The programme pursued by McCloskey and by Carden *et al.* (2009a, 2009b) and Carden and Courtemanche (2009) suggests that commerce is an input into the development of

virtue rather than an input into the development of vice. Further, it also suggests that from the consumption perspective, wealth and virtue are complements rather than substitutes. While these estimates are imperfect, the debate over the social effects of free markets requires critical engagement with the insights of Mises and Hayek. Translating this into a Smithian context, adopting the position of Smith's impartial spectator (see Smith, 1757 [1984]) does not impart to the observer the ability to make appropriate judgments about how resources should be organised.

Rational economic calculation means that capital goods will be arranged in a pattern that is consistent with consumers' ultimate preferences for consumable output both now and in the future (Garrison, 2001). Voluntary institutions also allow for the generation of a rational political, social and moral order. The information needed for rational calculation will be revealed as part of the voluntary process itself (cf. Buchanan, 1982). Institutional conditions under which co-operation takes place can be specified somewhat vaguely; however, the knowledge problem implies that we are not and never will be in a position to reorder society in such a way as to render involuntary processes capable of generating order.

Conclusion

It is important to note that Mises' contribution demonstrates that global socialism is impossible, not that small communes cannot function. The critique of capitalism to which Mises was responding was firmly in the Marxian tradition. The alleged crippling flaw of capitalism in this construction was its 'irrationality', and the irrationality of the anarchy of production was what kept capitalist societies from reaching the full potential that was only possible under scientific socialism. Under socialism, the abolition of private ownership of the means of production would blossom into material super-abundance (Boettke and Leeson, 2005).

It is also important to note that the problem of economic calculation differs fundamentally from the problem of mathematical calculation or the problem of model calibration. To engage in economic calculation requires anticipations and expectations about the future conditions of the market; it requires formation of expectations about future events and preferences that cannot be known. Life is also a process of trial, error and learning. As the philosopher enjoined us, 'know thyself'. This is a lifelong process. If we do not know ourselves, it remains a very dicey proposition to claim that we can know, in any meaningful sense, what is best for others.

Mises' economic criticism of socialism rested on the firm belief that even under the best of circumstances, it would be impossible for a society without private ownership of the means of production (and, therefore, without the money prices generated by exchange) to appraise factors of production and determine the proportions in which those factors should be used in order to produce final output. Furthermore, the profits and losses that are generated on the market provide crucial guidance to entrepreneurs and innovators. Guidance is replaced with utter darkness when the means of production are not privately owned.

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1. For discussions of the etymology of the term 'capitalism', see Hoppe (1989) and Reisman (1996). See also McCloskey (2006, pp. 1–60) for a discussion and elaboration of this definition of capitalism.
2. See in particular Book I, Chapter 1 ('Of the Division of Labour') for a detailed explanation.
3. Schumpeter (1996, pp. 383ff.); cf. Mandel (1990 [1976], p. 18).
4. The historical evidence demonstrates that the exact opposite was the case: 'Between 1780 and 1860 . . . British national income per head doubled – this even though population also more than doubled' (McCloskey, 1996, p. 243). Evidence on wages also suggests that the lion's share of the gains from industrialisation went not to capitalists or landowners, but to unskilled workers (Clark, 2007, pp. 272–299).
5. The first two quotes are from Marx via Tucker. The third quote is from Tucker. See Böhm-Bawerk (1949) and Sowell (1985) for exhaustive treatments of the Marxian system. Sowell is critical of Böhm-Bawerk's interpretation.
6. See Caplan (2004) and Boettke and Leeson (2004, 2005) for discussions.
7. The tacit knowledge example is from a lecture by John V. C. Nye at the 2005 Institute for Humane Studies Social Change Workshop.
8. See Leeson and Subrick (2006) and Pennington (2011) for further discussions of the robustness of liberal political economy in light of Mises (1920 [1990]) and Hayek (1945). In addition to Leeson and Subrick (2006), the other essays in Volume 19 (2–3) of the *Review of Austrian Economics* apply the concept of Robust Political Economy to several contexts.
9. This view is criticised by Postrel (1998) and Carden (2008).

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