

# The Two Conflicting Approaches to the Concept of Capital within Economic Thought

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## Abstract

*The concept of capital is probably one of the most disputable topics within modern economic thought. Differences between the various theorists on the definition of capital are almost endless. However, the need for a consistent definition of capital is based not only on purely terminological, but also operational considerations. Developing a theory using loosely defined terms is problematic in many ways. There are numerous cases in which researchers use the same term to refer to different things, without counting here the many popular meanings of the term capital. Studying the origin and meaning of the concept of capital is of paramount importance for any systematic theory which aims at explaining economic phenomena.*

**Key words:** *capital theory, factors of production, subjective theory of value, objective theory of value, monetary value*

**JEL Classification:** *B12, B13, D24, E22*

## Introduction

Capital theory is probably one of the most interesting and most debated topics related to political economy. Every renowned economist practically introduced his own concept of capital, differentiating himself more or less in this respect. I believe that despite the many superficial differences, all capital concepts can be grouped into two broad categories, a *subjective* and an *objective* one.

*The objective view* regarding capital was promoted by Adam Smith. It considers that the essence of capital resides in *physical goods* which have the ability to produce other goods and services. This view was extremely influential in the time of Adam Smith, but certain aspects of it still appear in modern economic thought. On the other hand, *the subjective view*, which seems to have been introduced by John Bates Clark, considers capital to be a monetary sum, an “investment fund” at the entrepreneur’s disposal.

In order to illustrate the two conflicting views on capital, I propose to analyse the works of two renowned economists, namely Carl Menger and Adam Smith, underlining the fact that each of them uses the term capital in a fundamentally different manner. Obviously, the problem is not purely terminological, but it also has direct implications for economics as a science. Studying

economic phenomena using different analytical tools necessarily leads to different recommendations regarding economic policies.

The research methodology corresponds to the traditional methods of political economy, namely critical literature review and verbal logic. As the research is qualitative in nature, I consider that the research methods employed are fitted in order to reach the main goal of the article.

## Critical Literature Review

Apparently, the word *capital* has been used from ancient times until the medieval period to signify the *principal* of a loan, in opposition to the interest on that amount<sup>1</sup>. It should be emphasized that the main feature of this sum of money was that it had the ability to “produce” interest, namely to create a surplus value. However, scientific research has come relatively quickly to the conclusion that money *per se* is sterile<sup>2</sup>. It lacks the capacity to be productive in any way<sup>3</sup>.

Developing the idea that money is sterile soon led to the first major change in the concept of capital. If money is not productive, respectively if it is not able to produce surplus value (interest), it was considered that this productive capacity must be found elsewhere – namely in goods. The first prominent researcher who made this judgment and hence altered the notion of capital was, according to some sources, Turgot<sup>4</sup>. He suggested that money by itself cannot “produce” interest, but the goods that money can buy are by their very nature productive. Thus, Turgot defined capital as “saved stock of goods”<sup>5</sup>.

However, Turgot’s definition has lost sight of the main feature of capital, namely its ability to “produce” income. This fact remained unnoticed for a long period of time. The one who first noticed this mistake made by Turgot was none other than Adam Smith. The Scottish economist, considered by many the “father of modern economics”, said that “the saved stock of goods” has two main sub-categories, namely goods which are intended for immediate consumption and goods that are intended to bring an income to their owner. According to Adam Smith, only the second category of goods can correctly be called capital, because only those goods are used in an *acquisitive* way.

However, Smith himself has made a second major alteration to the meaning of the word capital. Whether Smith was aware of this or not is debatable. The Scottish economist noticed that the concept of capital can be applied both at an individual and at an aggregate level. This different way of applying the term has led to a subtle change in the concept, essentially because there is a major dissimilarity between a person’s capital and society’s capital. Individuals can earn an income not only by *producing* goods and services, but also by *loaning* existing stocks of goods to other individuals<sup>6</sup>. Society *as a whole* can only *produce* new stocks of goods in order to increase general wealth.

<sup>1</sup> Böhm-Bawerk, E.v., *The Positive Theory of Capital*. New York: G. E. Stechert & Co, 1930, p.24; Fetter, F., *Capital, Interest, and Rent: Essays in the Theory of Distribution*. Kansas: US: Institute for Humane Studies, 1977.

<sup>2</sup> This conclusion (which is correct from a rational point of view) was clearly supported by the Catholic Church who believed that there is a divine prohibition on practicing interest on loans (also known as usury). For this reason, the Church has not only helped many researchers in the attempt to justify that interest is unnatural, but also directly intervened in the market by introducing a prohibition on interest loans, see Böhm-Bawerk, Eugen von. *Capital and Interest: A Critical Analysis of Economic History*. London: Macmillan and Co., 1890, pg 18.

<sup>3</sup> Mises, L.v., *The Theory of Money and Credit*. New Haven: Yale University Press, 1953, p. 88.

<sup>4</sup> Böhm-Bawerk, E.v., *The Positive Theory of Capital*. New York: G. E. Stechert & Co, 1930.

<sup>5</sup> Idem, p. 25.

<sup>6</sup> Including here also durable consumption goods: land, buildings, vehicles, etc.

Thus, as Böhm-Bawerk writes<sup>7</sup>:

*Individuals, that is to say, can make a gain, not only by the production of goods, but also by lending to other individuals for a consideration goods which are destined in themselves to immediate consumption, such as houses, masquerade dresses, furniture, etc. But the community, as a whole, cannot enrich itself otherwise than by the production of new goods. For the community, then, the conception of "means of acquisition" coincides with the otherwise narrower conception of "means of production".*

The two concepts introduced by Adam Smith, namely *Private Capital* and respectively *Social Capital*, are totally distinct from a logical point of view. The new concept (Social Capital) was included in the theory of *production*, taking its place in the renowned factors of production triad (Land, Labour and Capital), while the old concept corresponds to the theory of *distribution*, representing a fundamental source of income.

The change made by Adam Smith to the notion of capital added another notable aspect. In this sense, capital has become more or less synonymous with *tools* of production (defined as produced factors of production), tools which were considered by many researchers as being the "real" manifestation of capital.

The triad Land, Labour and Capital was promoted by the classical economists, especially Smith and Ricardo, and used (in an unaltered form) in the theory of production until the early twentieth century, when many voices have stressed the need for reformulating the concept of capital<sup>8</sup>. The main problem is that the classical approach associated each factor of production with a particular category of income i.e. Land with rent, Labour with wages and Capital with interest. This classification seems more likely to correspond to the political stratification of the English society at that time, especially because land owners were a social class apart from the capitalists and workers. However, in the modern economic world, such a tripartite division loses any meaning (due to its inaccuracy in solving practical problems) and the notion of capital as "tools of production" is almost totally replaced by the concept of capital as "monetary value", which is universally employed in business practice. The fact that both rent and interest are phenomena that permeate the price system and do not correspond to a specific group of productive agents (whether natural or artificial) is something that seems increasingly difficult to challenge. However, it is interesting to note how the social stratification in England in the 18<sup>th</sup> and 19<sup>th</sup> centuries affected political economy through the writings of the classical economists.

## Conflicting Capital Concepts

After a brief review of the origin of the word capital and the various changes incurred by this concept throughout history, the next step required to undertake a systematic research is to seek a definition that provides a maximum of consistency from an economic point of view. The aim of this approach is an operational and not purely a terminological one. The problem of defining capital is not only an intellectual game, but expresses the fundamental need for a consistent theory.

As I mentioned earlier, it is hard for one to find a topic in the field of economics where the different views would be more divergent than within capital theory<sup>9</sup>. Since an exhaustive research regarding the concept of capital is an academic paper in itself, I will only attempt to

<sup>7</sup> Idem, p. 26.

<sup>8</sup> Fetter, F., *Capital, Interest, and Rent: Essays in the Theory of Distribution*. Kansas: US: Institute for Humane Studies, 1977.

<sup>9</sup> One of the most complete and systematic reviews regarding capital and interest is made by Böhm-Bawerk in his three volume book (see bibliography). Another book, although less systematic in nature, regarding the topic of capital, is F. Fetter's "*Capital, Interest and Rent*".

point out that essentially all of the concepts (which were historically employed under the umbrella of “capital”) can be grouped, in the opinion of the present author, into two main categories. To serve this purpose, I chose two famous economists as representatives, namely Carl Menger and Adam Smith. Each of them represents an exponent and promoter of a different view – Carl Menger (at least after 1888) considering capital as a monetary value while Adam Smith defined capital using the renowned phrase “*produced factors of production*”.

### The subjective view – Carl Menger

Carl Menger, one of the promoters and probably the most passionate supporter of the subjective theory of value, had a sinuous evolution in his view regarding capital. In his *magnum opus*, published in 1871 (“Principles of Economics”), the Austrian economist defines capital as “*quantities of economic goods that are available to us in the present for future periods of time*”<sup>10</sup>. Considering the way in which Menger uses the notion “economic good”, it can be seen from the above definition that he includes labour in his capital concept<sup>11</sup>, but excludes durable consumer goods. While recognizing explicitly that labour and land have certain characteristics that distinguish them from other economic goods, the researcher correctly upholds that their value is determined according to the same economic laws that govern the value of any other good or service<sup>12</sup>. However, in the short appendix of his book devoted exclusively to capital, Menger becomes somewhat confusing. The Austrian economist suggests that extending the notion of capital (to include labour, land and ultimately consumer goods) would result in a concept synonymous with wealth. Further explanations regarding the essential difference between wealth and capital are particularly ambiguous<sup>13</sup>. It is possible that this ambiguity is a result of the fact that Menger’s concepts regarding this topic were not yet firmly established. A change of opinion throughout his lifetime is clearly suggested by his writings.

What is particularly interesting is that, seventeen years later (namely in 1888), Menger published an article under the title “*Zur Theorie des Kapitals*”, dedicated wholly to the concept of capital. The notions and definitions used in the article are somewhat different from those employed in 1871. In this short text, appeared in the famous publication “*Jahrbüchern für Statistik und Nationalökonomie*”, the author classifies all existing theories on the topic of capital into three broad categories based on logical oppositions, i.e. “*Capital*” is assumed to be:

- a. *first, those parts of an individual's assets devoted to generating income as opposed to the so-called Gebrauchsvorrat (assets designated for consumption);*
- b. *second, the means of production as opposed to the products themselves, in other words, that which will be consumable as opposed to that which is consumable;*

<sup>10</sup> Menger, C., *Principles of Economics*. Auburn, Ala: Ludwig von Mises Institute, 2007, p. 303.

<sup>11</sup> Menger divides the concept of economic goods into two categories: *material goods* and *useful human actions* (of which by far the most important action is labour). One can easily observe that in the mengerian framework labour cannot be considered a good of the first order (consumption good), which means that it automatically enters under the broader concept of capital.

<sup>12</sup> Menger, C., *Principles of Economics*. Auburn, Ala: Ludwig von Mises Institute, 2007, p. 165-175.

<sup>13</sup> See the following passage from the Appendix to “*Principles of Economics*”:

*“The most important difference between capital on the one hand and items of wealth that yield an income (land, buildings, etc.) on the other is that the later are concrete durable goods whose services themselves have both goods character and economic character, whereas capital represents, directly or indirectly, a combination of economic goods of higher order (i.e., complementary quantities of these goods) whose services also have economic character and therefore yield income, but whose productivity is of an essentially different nature than that of durable wealth that is not capital”.*

- c. *third, “products“ designated for further production as opposed to other kinds of goods designated for production (natural resources and labor!).*

Menger argues in this article that all three oppositions raise conceptual problems and that economics has taken the term “capital” from the usual business vocabulary and gave it a meaning that is totally different from commercial usage<sup>14</sup>. Furthermore, the Austrian author seems alarmed regarding the tripartite terminology introduced by Adam Smith (namely the famous Land, Labour and Capital triad) especially because it focuses more on the physical origin of the goods rather than their economic characteristics<sup>15</sup>. For Menger, dividing property into things offered directly by nature (Land) versus things obtained through labour (Capital) is totally irrelevant from an economic point of view<sup>16</sup>. Tracing back goods to their original components “*which are rooted neither in reality nor in the economic considerations of business practitioners*” is according to him an “*ambiguous abstraction*”<sup>17</sup>.

Finally, Menger seems to emphasize the need for a return to the original meaning of the term, common to commercial usage, respectively “*sums of money devoted to income generation*” (also called “Active assets”)<sup>18</sup>. Obviously, the main characteristic of these money values is that they allow entrepreneurs to make economic calculations. It is precisely because of this fact that the physical composition of goods (machinery, construction materials, etc.) is not necessarily relevant to businessmen<sup>19</sup>. The assets themselves do not appear in business calculations, but their monetary values do. It is of paramount importance, in Menger’s opinion, that economics as a science should return to the study of phenomena typical to commercial usage and focus less on abstract theories which do not relate to daily economic life<sup>20</sup>.

Hayek, in his preface to “Principles of Economics”, argues that Menger sought to rehabilitate the abstract concept of capital, “deformed” by Adam Smith, by defining it “*as the money value of the property devoted to acquisitive purposes*”<sup>21</sup>. Thus, after a sinuous evolution, Carl Menger attained a concept of capital that seems to be in agreement with the subjective theory of value, which he so vigorously popularised.

<sup>14</sup> Menger, C., *On Capital Theory*. Jahrbüchern für Nationalökonomie und Statistik (Conrad's Jahrbuch), 1888.

<sup>15</sup> However, it is interesting that Menger himself does not appear to use the monetary value concept anywhere in his “*Principles of Economics*”, but seems to operate with physical quantities of goods, see Menger, Carl. *Principles of Economics*. Auburn, Ala: Ludwig von Mises Institute, 2007, pg. 303, 304. This proves (to a certain extent) that the reputed Austrian economist changed his opinion on these issues, integrating them into the subjective theory of value.

<sup>16</sup> Idem.

<sup>17</sup> Idem.

<sup>18</sup> Another term which is particularly suggestive would be “*working money*” - money devoted to income generation.

<sup>19</sup> Menger’s article on capital seems to be a possible source of inspiration for Ludwig von Mises. Both his focus on economic calculation and his definition of capital appear to be misesian in nature. Ludwig von Mises uses almost the same phrase to define capital in his treatise “Human Action” and stresses almost the same related issues as Menger (see pg 259-264 of “Human Action”).

<sup>20</sup> One can raise a very interesting question in this case: How did this shift in Menger's view occur? A possible reason for changing his conceptions might be a disagreement between Menger and, probably his most eminent student, Eugen von Böhm-Bawerk on capital and interest. There are sources that state that Menger even said that his student’s theory is “one of the biggest mistakes ever made” see Endres, A. M. “The Originis of Böhm-Bawerk’s ‘Greatest Error’: Theoretical Points of Separation from Menger”. *Journal of Institutional and Theoretical Economics* 143, nr. 2 (1987): 291-309. Endres suggest that this divergence of opinions derives from the fact that Böhm-Bawerk had a very “objectivist” vision compared to his mentor, a vision which decisively influenced his work.

<sup>21</sup> Menger, Carl. *Principles of Economics*. Auburn, Ala: Ludwig von Mises Institute, 2007, pg 28.

## The Objective View – Adam Smith

Because of his major influence in political economy, it is probably useful to briefly explain Adam Smith's theory of capital. "The father" of Political Economy, was the one who introduced and popularized the objective view regarding capital, considering that the substance of the term resides in physical goods (which are not "nature given" but rather "created by man") with productive capacities.

The famous classical economist begins with the simple premise that with the expansion of the division of labour, a man's labour can only provide for a small part of his needs. Therefore, the person will not only have to wait until his product is finished, but also sold. Thus, it clearly results from the premises that the individual must have a stock of goods (food, raw materials, tools, etc.) that will be necessary both to complete his work (e.g. tools) but also for his general subsistence until the finished good is finally released on the market<sup>22</sup>.

Regarding the components of a nation's wealth, Adam Smith includes three subcategories: *goods destined for immediate consumption* (food, clothing, housing, etc.), *fixed capital* (tools, machines, buildings, "land improvements" and people's skills) and *circulating capital* (money, supplies, raw materials and finished goods held in warehouses by traders). To achieve the main distinction (consumer versus capital goods), Smith includes under the notion of capital *any stock of goods* which is expected to yield an income to the owner<sup>23</sup>. In order to distinguish between fixed and circulating capital, the Scottish economist suggests that any good that generates profit without a change of ownership will be considered fixed capital, while any good that generates profit by selling it (respectively with a corresponding change of ownership) shall be considered circulating capital.

On the other hand, the objective view introduced by Adam Smith regarding capital is made evident from the fact that he does not consider renting durable consumer goods to be a source of revenue for society as a whole. The following passage is suggestive in this regard<sup>24</sup>:

*"Though a house, therefore, may yield a revenue to its proprietor, and thereby serve in the function of a capital to him, it cannot yield any to the public, nor serve in the function of a capital to it, and the revenue of the whole body of the people can never be in the smallest degree increased by it".*

It is pretty much obvious from the above passage that Smith considers that consumer goods which are rented by the owner to other people are not capital because they do not yield revenue "for the general public"<sup>25 26</sup>.

The emphasis placed on the origin of goods (natural as opposed to anthropic), their physical quantities (as opposed to their monetary value) and aggregation at the level of the whole society (social capital as opposed to private capital) led to shaping the objective view regarding capital, approach which was undertaken by numerous economists later on. Thus, based on Adam

<sup>22</sup> Smith, A., *Avuția Națiunilor*. Publica, 2011, pp. 163-165.

<sup>23</sup> Idem, p. 167.

<sup>24</sup> Idem, p. 170.

<sup>25</sup> This is somewhat contradictory to the fact that ultimately society's capital must equal the sum of its individual components, i.e. each man's individual capital. Thus, it is relatively strange that Smith believes a rental house represents capital for the owner, but the same house does not fall in the category of capital at an aggregate level.

<sup>26</sup> Equally questionable is the distinction made by A. Smith between "productive" and "unproductive" work. In his terminology, "productive labour" is that which leads to the obtaining of a tangible object. Thus, immaterial goods such as services are considered the result of "unproductive work". Smith clearly fell into the trap mentioned by Menger, i.e. considering that the goods-character of a thing is purely due to its physical qualities and not to its ability to satisfy human needs.

Smith's insights, this objective view gave birth to the concept of capital as "produced factors of production".

## **The Two Conflicting Views in Economic Thought**

As can be easily seen, consensus between economists is lacking, even concerning the theoretical foundations, i.e. the basic terms. The absence of a clear paradigm does not permit us to reach unambiguous conclusions based on the various theoretical approaches.

However, virtually all theories regarding capital fall into two broad categories: those that consider capital a *concrete stock of goods* (objective in nature) and emphasize physical productivity and those that consider capital as a *monetary value*, a unitary fund of value which investors have at their disposal (subjective in nature, focusing on people's preferences and economic calculations).

*The first category* has its origins in England, country which was heavily stratified from a social point of view, and was promoted by the classical economists (especially Smith and Ricardo), although later it found supporters worldwide<sup>27</sup>. The focus rests on logical oppositions regarding the physical/technological origin and characteristics of goods (natural versus produced factors of production, goods destined for consumption versus goods destined for production). This is practically the theoretical framework from which the factors of production triad and the corresponding income categories emerged. For a long time period, this theoretical perspective was considered the economic approach *par excellence*, while the other perspective, namely the subjective one, was frowned upon as being more of an "accounting" rather than an "economic" approach<sup>28</sup>.

*The second category* of capital theories introduced a psychological perspective in economic thought, seeing in capital a value fund, a monetary expression which necessarily has its roots in individuals' utilities. Supporters of this view claim that the economic character of goods is strictly related to people's perceptions regarding things and not necessarily to their physical characteristics. Moreover, in common business practice entrepreneurs conceive capital as a sum of money. For them, it is immaterial whether their assets are artificially produced or nature-given. The eternal discussion regarding the distinction between land and capital has no significance for the entrepreneur. He is only concerned about their market value.

The first economist to introduce the value concept of capital was apparently John Bates Clark in 1888<sup>29</sup>. He developed an abstract concept of capital (naming it "pure capital" as opposed to "real capital") which represents a monetary fund, a value amount which the entrepreneur has at his disposal. Moreover, Clark believed that rent is not a phenomenon specific to natural agents, but that any amount of money obtained from a productive agent (whether natural or not) can be considered rent. According to him, interest – as a sum of money linked by a relationship of proportionality to the principal amount – is nothing but rent generated by capital<sup>30</sup>. Of course, this view was supported by the fact that Clark was American by nationality. He was not influenced in any way by England's social stratification, in contrast to the classical economists.

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<sup>27</sup> A few renowned supporters of the objective capital view are: Adam Smith, David Ricardo, Böhm-Bawerk (partially), Ludwig Lachmann, Richard von Strigl, Karl Marx etc.

<sup>28</sup> Fetter, F., *Capital, Interest, and Rent: Essays in the Theory of Distribution*. Kansas: US: Institute for Humane Studies, 1977.

<sup>29</sup> Idem.

<sup>30</sup> Idem, p. 19-21.

Given the American pragmatism characteristic to the commercial environment, a concept such as the Land, Labour and Capital triad was completely foreign to business practice<sup>31</sup>.

Many economists attempted to perfect the subjective theory of capital, among them Menger, Fetter, Fisher and Mises. The emphasis has been shifted from the physical characteristics of capital goods towards subjectivity and human choices. The term psychic profit was introduced in the economic language. The “psychological” school of economic thought, having its pivot in the law of marginal utility, brought decisive arguments in favour of the subjective view of capital.

After this short incursion in the broader theoretical approaches regarding the definition of capital, it is recommended to take a moment to answer a pragmatic question, namely: Why it is useful to know these different theories? Is this not a gesture of pure pedantry, a sophisticated waste of time, an intellectual game without any stakes involved? The answer would be no. Besides the logical consistency generated by using clear and well defined theoretical concepts there is another powerful argument in favour of studying basic terms and concepts. Ultimately, choosing among the two conflicting concepts of capital will automatically alter an economist’s understanding regarding the rate of interest. It is no wonder that the vast majority of economists who have used the objective conception of capital turn out to indicate the physical productivity of capital as the main source (often even exclusive) of the interest rate, while those who used the subjective concept came to believe that consumer preferences are the sole origin of the above mentioned phenomenon.

## Conclusions

It is clear that until the present moment one cannot speak about consistency in economic thought regarding the concept of capital. Almost every reputable economist introduced a concept that has proven to be more or less different from his predecessors. However, instead of making efforts to clarify this debate once and for all, economists appear to have abandoned the subject altogether.

Although opinions differ regarding this issue, two main theoretical views can be observed, i.e. those which see in capital a stock of physical goods destined for future production and those which see capital as a monetary value, a fund available to investors with the purpose of generating profit.

The differences between the two categories are based on a much broader theoretical separation point. Essentially, the two concepts emanate from a dichotomy in the theory of value – i.e. the subjective theory of value, which states that the value of goods is determined strictly by consumer preferences versus the objective theory of value, which considers the goods are valuable in themselves.

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<sup>31</sup> Practical aspects regarding the implementation of the classical view were also raised by accountants, see Fetter, Frank. *Capital, Interest, and Rent: Essays in the Theory of Distribution*. Kansas: US: Institute for Humane Studies, 1977, pp. 151-153.



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