

# Money, Credit, Capital and the State

## On the Evolution of Money and Institutions

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**Abstract** This paper combines several important arguments, which have puzzled economic theory for decades, to arrive at a more adequate description of the current global crisis. The main theoretical innovation is to view the long-run economic evolution as a stepwise evolution of money forms. Moreover, as indicated in the title, this development of money forms is closely linked to the development of social institutions, in particular, state institutions. Capital, the most recent form of money, today has to be understood as an omnipresent algorithm, as a growth imperative implicit in social institutions and internalized models. The task of evolutionary political economy thus will be to provide an adequate theoretical counterpart to mirror these processes. This paper explores how far a careful reconsideration of received economic theory can contribute to this task.

### 1 Money

All human societies with a developed political economy are monetary economies. The very existence of the interplay of production and consumption activities of a society's members implies that periodically reappearing habits, of relations between activities, become visible and are memorized. At a certain point of development, the repetitions—using days and years as time units—are externalized as signs on physical carriers. Written language serves as a special device to adjust and to regulate activities according to processes going on in the natural environment of society. The immediate importance of the new device is evident: advantageous behavior can be transmitted across generations without relying on spoken language only. Sign systems on physical carrier systems thus acquire an important

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social role, a metaphysical (i.e. more than physical) status, which stabilizes social evolution.<sup>1</sup>

In economic theory, the three basic functions of money usually mentioned in standard macroeconomics—‘store of value’, ‘unit of accounting’, and ‘medium of exchange’—all refer to this specific role.<sup>2</sup> As for growing societies, production is split up in time and space, as are its services and products. To bridge time and space, a memory of the performed activity is materialized as a sign on a physical carrier. This unity of physical matter and its relation to the members of society stores what is called ‘social value’; its more mundane name is ‘money’. Since contributions to social evolution are so different in kind—and even more so the more developed and complicated the society becomes—intra-social organization calls for the measurement of relative social value.<sup>3</sup> Again, the sign system of money can help by adding a scalar size, the units of social value accounting, to the material carrier. If these two prerequisites are given,

- (1) the commitment of the members of society to accept a system of social value relations expressed on a physical carrier system;
- (2) the acceptance of its specific quantitative expression as a set of certain relative money amounts;

Only then is exchange of social value via money as the medium of exchange possible. The existence of money thus coincides with the existence of social organization, already at a very early and primitive level.

But even at this lowest level, several implicit features of a monetary economy become visible, features usually not explicitly articulated in standard economic theory. Acceptance of a certain money system can be either voluntary or forced upon the members of society—or something in between. In any case, acceptance reflects the *power relations* within a society.<sup>4</sup> If power is concentrated in the hands of a small group of members of society, it is evident that the portrait of the leader of this small group on the coins used in this society should keep authority of the powerful alive. In more democratically organized systems with power only temporarily transferred to institutions, and recurrently checked by feedback mechanisms involving all members of society, the monetary system carries the marks of the

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<sup>1</sup> There is, of course, an extensive body of literature discussing the historical and logical roots of sign systems such as money. European social scientists representing the academic turn of the New Left in the aftermath of the youth revolt of the late 1960s rediscovered this topic, e.g. (Müller 1977; Thomson 1972; De Brunhoff 1973).

<sup>2</sup> Compare (Mankiw 2010, Chap. 4).

<sup>3</sup> This interwoven character of the social value system and the institutional framework of social institutions is also reflected in modern mainstream economics, see (Walsh 2010), or (Mishkin and Eakins 2011).

<sup>4</sup> Some authors have emphasized the strong connections between the power structure implicit in money relations, and those existing in other social domains, e.g. symbolically amplified cultural hierarchy or gender hierarchy. In some cases, it is even suggested that the former is determined by the latter. Compare (Heinsohn 1984).

specific institutional setting prevailing in that society. The borders between voluntary and forced participation in the prevailing monetary system increasingly get blurred if one considers the next long-run trend.

In ancient Greece, the hegemony of Athena's coin, the famous silver owl, needed the rich silver mines close to the city as well as the mighty fleet of Athens. The threat of punishment in case of disobedience was very visible. This obvious backup for the power of Athena's monetary system gave it a very concrete character, a metallic taste. Since then, money has experienced a *process of ever increasing abstraction*. With the establishment of more sophisticated exertions of power, banknotes could free the availability of the monetary carrier medium from the pressures of production of precious metal. Abstraction thus proved the primacy of the social sources of money's force, as compared to the inherent social value of the carrier medium. The social sources of voluntary subordination under a monetary system became manifold and more binding as the next best alternative—voluntary disobedience—was losing ground quickly when the growth of monetary economies took off.<sup>5</sup> Nowadays, money is just a rapid change of patterns on a computer screen, and so the mission of the abstraction process starting with the original problem has been completed. The overwhelming majority of human individuals have no choice but to voluntarily join monetary rules; on the way, the content of the concept 'voluntary' has lost its meaning.

Nevertheless—and despite the highly complicated setting of institutions and democratic feedback loops<sup>6</sup>—contemporary money still is a sign system that refers to abstract social value. For a single individual, one out of seven billion humans worldwide, the evaluation of relative social value of all the activities and products with which it is concerned certainly cannot be derived by insight into this complicated, global production structure. This difficulty, the inability to grasp the complexity of the global production, lies at the root of subjective value theory, of microeconomic theory as it has been taught since Walras, Menger and Jevons (around 1874). This theory thus is not just an ideological vehicle to fight the macroeconomic exploitation theories of the intellectuals flirting with the labor movement of the nineteenth century. Subjective value theory addresses a real problem of households: How to order purchases if a given amount of monetary income can be spent—the starting point for axiomatic utility theory.<sup>7</sup> But as this set of decisions falls apart from an understanding of production and reproduction of the overall political economy, the human individual is separated into an economic, utility maximizing entity and a political entity engaging in the multi-layered

<sup>5</sup> See (Davies 2002) as reference for a detailed history of this process.

<sup>6</sup> In a democracy, the institutional setting is repeatedly restructured by a system of second-order institutional processes (including electoral processes) designed to enable entry and exit of first-order institutions. This, of course, implies that a dangerously smooth transition to non-democratic governance can occur.

<sup>7</sup> A faint memory of the link to the overall social process can be seen in J.M. Keynes emphasis on the concept of effective demand. In denouncing needs, which cannot be translated in money terms as less important, he intuitively subscribes to classical political economy.

processes of more or less democratic feedback control. Production units, the other micro-unit covered by microeconomics, is the archetype of the decision-making entity put in the center of analysis. It is their (hypothesized) stylized decision problem that is grafted onto household behavior to describe it as utility maximization, the analogue to profit maximization. Again, entrepreneurs are schizophrenic: On the one hand, there is the input cost minimizing (and in the sequel, profit maximizing) entity that is completely ignorant as to the political evolution of its environment, and on the other hand, there is the legal institution with special status in the legal system and vested interest political evolution.<sup>8</sup> For both microeconomic types of agent, money (i.e. social value) is the exogenous constraint that makes needs and profit possibilities appear scarce. The arrangement of social activities and their guiding institutions seems to be out of range of the microeconomic discourse, but if money is interpreted as a first form of a regulating device shaping the evolution of the former, then the old tenets of classical political economy appear on the theoretical horizon again. The sign system of money still refers to the arrangement of human activities, to the setup of time spent at an enormous variety of occupations worldwide. To see how a crisis of social evolution is translated into, and amplified by, a crisis of money forms, the renaissance of political economy in the form of Keynesian macroeconomics has to be briefly reviewed.

I will leave this argument on the role of money at this point, and take it up as a loose end in the last section.

## 2 Credit

At first glance, credit seems to be just another face of money: Accepting a coin instead of a certain amount of a commodity—usually in exchanges at markets—can be understood as giving credit, literally to believe (*credo*) in the validity of a sign on a carrier medium. The point, of course, is that it is not the partner in the exchange transaction to whom this believing refers. It rather is belief in the enduring trustworthiness of the social system which provides the environment for the exchange act. Money interpreted as credit enlarges its original function of bridging space and time for a species that has developed a common consciousness of mutual commitment. When, towards the end of the Middle Ages, merchants in Venice received credit from the wealthy local banks, this credit always came in the form of money.

But not all money can be considered to be credit in the more narrow sense introduced by these early global merchants and explorers. To some extent, the distinction is merely based on the temporal scale that is relevant. The coin in the pocket is only short-run property, easily exchanged at the next opportunity, whereas

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<sup>8</sup> The classics saw this dichotomy very clearly and dubbed it the double existence of the citizen (the politically emancipated member of society) and the bourgeois (the owner of a factory engaged in profit maximization).



money taken as credit by the above mentioned merchant was used up during a journey that often took years. But this notion of difference in physical time is just the appearance of a more substantial difference, based on the emergence of an economic time scale. The coin in the pocket remains inactive; its sole function is to preserve a certain amount of social value by freezing it as a sign on a piece of metal. The money given as credit to the merchant not only remains property for a longer physical time span, but during the journey it indeed changes its form as well as its social value. By the actions of the merchant, a new social archetype, money as credit, becomes a process. This process, due to the ongoing change of money and commodity forms representing different systems of social value in different countries, produces its own type of time: economic time. Economic time runs parallel to but not synchronous with physical time.<sup>9</sup> Consider two journeys of merchants, the first taking 3 years of physical time, the second taking 6 years. Assume that at the end of the first journey, when the merchant comes back to Venice and sells all the commodities he has brought, that he owns an amount of money, which is five times as high as the sum with which he started. Assume further that, after the second journey, the analogue amount of money owned by the merchant is ten times the original credit. In that case, the speed of economic time of the two journeys would be equal, since the (fictitious) growth rate of credit-money per physical time unit is the same. It is the growth rate of the amount of credit-money which serves as measure the economic activity; if it falls to zero, then credit-money collapses and remains just money.<sup>10</sup>

While this view of credit emphasizes its role in stimulating the economic activity of merchants, it nevertheless is linked to a specific perspective on its relation to savings. For the classical political economists, the progressive role of those who use credit-money to transform it into economic activity was evident. Consumption was basically understood as the consumption of the feudal class, and the heroes of the new economic era were economic agents, who—contrary to the consuming feudal parasites—transformed money into economic growth.<sup>11</sup> Credit for the purpose of consumption was thus of no economic significance; if rich merchant families

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<sup>9</sup> Economic time did exist before the emergence of credit, but it remained invisible since it was hiding behind the rhythm dictated by the seasons, which was synchronous to the major field of economic activity: agriculture. The treatment of the concept of time in political economy is remarkably underdeveloped, which mainly seems to be due to a somewhat blind adoption of the formal apparatus of the natural sciences. Indeed, some insights from sociology, e.g. (Elias 1993), still wait for to be appropriately appreciated in political economy.

<sup>10</sup> In modern economic jargon, this is often expressed as 'money being a security with an interest rate of zero'. Evidently the determination of the set of securities bearing an interest rate of zero is further complicated if inflation rates (and the different possibilities to calculate them) are taken into account.

<sup>11</sup> From Adam Smith's arguments for the source of wealth to Keynes revival of the idea of the 'euthanasia of the rentier', progress has been identified as the advance from feudal (over-) consumption to productivity-increasing re-investment of entrepreneurs. This common anti-feudal trait, of course, is in stark contrast to the basic differences of the worldview of these two godfathers of modern economic thought. Compare (Foley 2006).

provided money for ‘Il Principe’, then no economic growth process was expected.<sup>12</sup> On the other hand, the working class was considered to be involved in the process of accumulation only as a passive element, using money as a medium of exchange for immediate physical reproduction, and never as credit-money. Credit for consumption thus was thought to be insignificant in explaining the essence of credit-money. Savings of non-feudal households played either the same role as inventories for production units— a tool to smooth the stream of income — or, if they became more systematically growing as in the rich city-states of northern Italy, they were collected in banks financing merchants. This latter process thus clearly represents emergence of a new division of labor within the class of non-feudal rich families<sup>13</sup>: one group provides credit-money, while the other uses it for exploration and trade. Note that this emergence needed at least two elements, (i) a certain vacuum within feudal power structures and (ii) a certain level of money hoardings.<sup>14</sup> It might well be that there is a more general—and acute—lesson to be learned for the emergence of institutions in the current situation.

Only when the labor movement gained significance towards the end of the nineteenth century did the savings of worker households start to play a macroeconomic role. Again the concurrent ideological turn to microeconomic reasoning prevented mainstream economic theory from recognizing the importance of this development.<sup>15</sup> It needed the Great Depression and, in the sequel, Keynes, Schumpeter and their followers, to reshape classical political economic theory to grasp some of the elements of the new era. Keynes rediscovered the importance of circular macroeconomic money flows, while Schumpeter—drawing to a considerable extent on Marx’s ideas—highlighted and sharpened the implications of the historical mission of entrepreneurs and innovation.<sup>16</sup> But by the time that happened, the form of credit-money had already developed into a new dominating process, capital. Credit-money as money for consumption thus only appears when the next metamorphosis of money forms has taken place.

Return now to the original add-on, which makes credit-money a historical and logical bridge between money and capital. While the existence of money is just a

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<sup>12</sup> What actually was expected from the feudal sovereign was a guarantee for political stability. Compare (Machiavelli, 1988 (1532)).

<sup>13</sup> At this point, the concept of a social class enters the argument. It turned out (and still turns out) to be of central importance for an analysis of capitalism. Despite the renaissance of mesoeconomics challenging the bipolar world of micro- and macroeconomics, (global) class analysis still has not reached the theoretical status it should have. Compare (Wright 2005).

<sup>14</sup> The first globally hegemonic country of merchant capitalism, the Netherlands, is another good example of the importance of these preconditions.

<sup>15</sup> In this context, the work of Veblen—certainly a maverick economist in his time—is remarkable, since he directed attention to the consumption behavior of the non-workers, the ‘leisure class’ [see (Veblen 1899)]. Deriving class membership from the ‘conspicuous consumption’ habits of persons rather than from their roles in the production process, he implicitly observes that to get credit for consumption purposes is a defining characteristic of the leisure class.

<sup>16</sup> See (Catephores 1994) for a more detailed explanation of this view.

reflection of the generally recognized unity of a prevailing social setting, the emergence of credit-money is a partial negation of money's universality: With the credit given by a specific member of society to a specific other member, the concerned money amount is not simply secured by the state monetary authority. It is additionally secured by a private contract between the two agents involved, a contract that itself is correctly called a security. Note that with this new development of a specific kind of credit-money there does emerge the concept of private economic agents—as opposed to the physical individuals inhabiting the world of simple commodity producing societies.<sup>17</sup> Note further that the use of contracts implies the emergence of a corresponding *specific law system*,<sup>18</sup> which in turn is built up by *a host of emerging institutions*. These institutions become necessary to assure that the procedures agreed upon by the involved parties in advance (as content of the contract) are actually executed as economic time proceeds, i.e. that commitment in the credit market becomes feasible.

The evolution of new institutions for new private economic agents evidently coincides with the use of credit-money—and this, of course, challenges the intellectual commentators of the time anticipating a clash with the already existing political institution of feudalism. When Montesquieu designed his famous idea of a division of power within the modern state, he did so on the basis of a careful comparison of empirically observed systems in different times and countries (Montesquieu 1748). Credit-money as a bridge to capital, i.e. the next form of money, also paves the way to an understanding of the form of political organization accompanying capital: the *nation state*. This newly emerging political organization freed itself successively from its feudal bonds to provide an *adequate structure of power relations* for capitalism. It did so by monopolizing coercive power and institutionalizing the links between private economic agents. Again this argument will be taken up in the concluding section.

Finally, one side-effect of the credit mechanism used by merchants has to be highlighted, since it unconsciously prepared the next step of social evolution: With their successful trading activities, merchants were indeed starting to increase global, average labor productivity. By buying, transporting and selling commodities (and sometimes slaves) to increase their working credit-money, some pre-existing specialization in the different parts of the world they explored<sup>19</sup>

<sup>17</sup> It is remarkable how mainstream microeconomics from 1870 onwards (starting with Walras 1874; Jevons 1871; Menger 1871) systematically confuses private economic agents and biological individuals. The major reason for that deficiency is the complete neglect of the evolution of money forms.

<sup>18</sup> Laws thus are man-made and not innate economic properties of human individuals. Note the sharp contrast of this perspective of *explaining the emergence and evolution of laws rather than discovering them*. Even the approach of experimental economics falls prey to this misconception of microeconomic ideology when it simply tries to discover innate economic laws differing from the ones stipulated by neoclassical doctrine, e.g. altruism.

<sup>19</sup> Compare, for example, the vivid description of global trade triangles in (Frank 1978).

entered global consumption, opened up new utility dimensions<sup>20</sup> or reduced average necessary labor inputs. Of course, such global effects were not recognized by the merchants themselves, and were additionally obscured by the fact that most advances were absorbed by the still powerful feudal elite. Nevertheless, ex post, an increase in global technological abilities as well as a widening of consumption spaces due to merchant (credit financed) activities is evident. With the next step of monetary evolution, this aspect of accommodating technological evolution proved to be one of the dominant elements of social progress.

### 3 Capital

If money not only is used as credit but assumes the form of a generally applicable program of accumulation, then it is called capital. Capital has all the features of credit-money but additionally, in the form of a mandatory algorithm, subordinates all strata of social organization. Credit-capital had explored and conquered society's environment. Capital also turns inside the more and more global society and its program takes hold of all humans and institutions to transform them into economic agents, into drivers of its abstract algorithm. Still, the appearance of the money involved in this process has not changed all of the properties related to the lower forms (general acceptance, importance of contracts and private economic agents, etc.), which still apply. There just is the metamorphosis into a general principle guiding the carrier systems instead of being guided by the latter.<sup>21</sup>

The program of the capital process in its most general form is rather simple and consists of the following commands: *Capital Algorithm*

For each member of the set of currently possible visions do ('vision loop')

Produce a vision of specific entrepreneurial activity

Check expected wage cost

Check expected interest on credit-money (vulgo 'capital cost')

Check expected effective demand

Compute expected growth rate of capital

Estimate the probability to achieve that growth rate

(continued)

<sup>20</sup> The change in the dimension of the utility space—some new commodities enter, others vanish—is one of the most important blind spots of mainstream economics, which evolutionary economics promises to shed light on.

<sup>21</sup> Karl Marx had anticipated this, and chose 'Das Kapital' and not 'Die Kapitalisten' as title for his opus magnus. In the second preface to this book, he explains that the notion of 'capitalist' is to be understood as an abstract algorithm (a 'Charaktermaske'), and not as an immediate reference to physical individuals (Marx 1857).



(continued)

End of vision loop

Choose the vision yielding the highest utility of a mean-variance utility function

Check if the selected vision's utility exceeds the expected utility of a supplier of credit-money

If the lender's utility is higher, then perform the chosen project, else become a supplier of credit-money.

This innocent algorithmic prescription generalizes what merchants and their bankers did with credit-money by the end of the thirteenth century.<sup>22</sup> But what makes the difference is the fact that, in the course of the historic development of capitalism from merchant capitalism to industrial capitalism,<sup>23</sup> the abstract form of this algorithm proved to be universally applicable to all kinds of activities of economic agents. A look around contemporary OECD countries reveals the fact that there is almost no aspect of life that is not permeated by the workings of the capitalist program.<sup>24</sup> In a sense, the monetary core of the activities of certain groups in early merchant capitalism<sup>25</sup> has turned from outside trade to all types of inside activity. In the end—in (Hanappi 1989) this stage is called 'integrated capitalism'—not only production units but every household and every institution has become a private economic agent following the abstract algorithm of capital accumulation. Concepts such as human capital and competence capital show that the higher degree of abstraction that money gave rise to enables and opens up an incredibly wide field of possible application. It is thus not surprising that, in the history of economic thought, a sharp turnaround took place: *the mirror image of the real course of economic development observed in its contemporary state started to be taken as its actual origin*. Transplanted into physical human individuals, from Robinson Crusoe to the more abstract homo oeconomicus, the private economic agent was considered to be the atom of 'social physics'.<sup>26</sup> From that

<sup>22</sup> Venice and Genoa had started to mint their own coins to support their conquest of world trade [compare (Braudel 1986, pp. 111–116)]. The less abstract forms of money are thus not simply substituted by a new form. Rather, they are only adjusted to accommodate the new hegemonic form of money. This could also be a lesson to be learned for the current crisis.

<sup>23</sup> For a detailed discussion of the stages of capitalism, compare (Hanappi 1989).

<sup>24</sup> The somewhat forgotten German social scientist Alfred Sohn-Rethel introduced an interesting hypothesis: Even the logical structure of humans' mental models is framed by the evolution of commodity producing societies (Sohn-Rethel 1978, pp. 103–133).

<sup>25</sup> Distinction by function separates bankers from merchants, distinction by location [following (Braudel 1986)] separates Brügge, Hanse cities, Northern Italian cities, Champagne, Antwerpen—and later Amsterdam.

<sup>26</sup> This expression was used by Auguste Comte to make clear that his vision of a future social science follows the example of the natural sciences (Comte, 1979 (1844)).



perspective, the true state of nature had been obscured in the past and only in full-fledged capitalism could the true and final character of social relations reveal itself. Once this final state is reached, history has ended—only some safeguarding to prevent external disturbances (modern economics calls them ‘shocks’) is needed.

It is interesting to see that with such a radical conceptual turn—mistaking a frozen mirror image as a parable of origin—not only evolutionary political economy becomes impossible; also money in its highest form of abstraction vanishes, since it becomes an innate feature of private economic agents. The current indecisiveness of mainstream economic advisers dramatically shows the impasse, which was taken a long time ago.

But the methodological turn of economic theory towards the crude atomistic perspective had several other severe consequences, too. Since the formalism adopted originally was a description of energy transformations of non-living, smallest elements of matter,<sup>27</sup> any description including the build-up of structures and clusters is simply impossible! The final issue emerging from that formalism in the natural sciences is the second law of thermodynamics, which states that, in the long-run, the stochastic trend towards an increase in entropy will prevail, i.e. a certain equilibrium state of (computable) maximum entropy will be approximated. The re-interpretation in microeconomic terms postulates this process as the working of market forces relating the owners of (‘scarce’) resources and in the long-run leading to a vector of relative prices—the correlate of maximum entropy in general equilibrium theory. Note that ‘prices’ in this context are exchange relations of quantities of commodities<sup>28</sup> and *not* a monetary expression of the social value of a unit of a certain commodity. To bridge—or, more ideologically interpreted, to disguise—this strange role of prices, the theory had to be complemented by the adoption of the so-called quantity theory of money. If maximum entropy is reached, vulgo ‘in general equilibrium’, the vector of relative exchange quantities can be translated into a vector of money prices by simply assuming proportionality to the amount of money signs (on carrier systems) in circulation as well as to an exogenously assumed speed of circulation. Evidently the money form used in the quantity theory of money is *not* credit-money or capital. In the pure form of general equilibrium theory (GET) *there is thus no endogenously developed theory of*

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<sup>27</sup> Compare (Smith and Foley 2002) for a detailed treatment of that isomorphism.

<sup>28</sup> It is surprising to see how, in 1871, one of the founding fathers of GET, Stanley Jevons, already spelled out its methodological break: “I have attempted to treat Economy as a calculus of pleasure and pain, and have sketched out, almost irrespective of previous opinions, the form which the science, as it seems to me, must ultimately take. I have long thought that as it deals throughout with quantities, it must be a mathematical science in matter if not in language. . . . The Theory of Economy thus treated presents a close analogy to the science of Statistical Mechanics, and the Laws of Exchange are found to resemble the Laws of Equilibrium of a lever as determined by the principle of virtual velocities. The nature of Wealth and Value is explained by the consideration of indefinitely small amounts of pleasure and pain, just as the Theory of Statics is made to rest upon the equality of indefinitely small amounts of energy.” (Jevons 1871, p. viii). Pleasure and pain are inborn features of a material smallest entity, just as properties of atoms in physics.

**money.** Money and prices are just as a veil thrown by a monetary authority over true and ‘natural’ exchange ratios.

A further dramatic consequence follows: If there is no theory of credit and capital, if the theory of social values is dissolved into predetermined preferences of a set of biological atoms moving towards its natural equilibrium via markets—then *there is no room for an understanding of the growth of structure*, of exactly those processes that constitute the emergence of life forms (of all evolutionary forms) living as temporary contradictions to the law of entropy.<sup>29</sup> The neglect of the evolution of money forms therefore is just the tip of the iceberg of the methodological sins of the atomistic turn. Growth, the central concept around which all types of biological theories are built, is explicitly excluded by assumption.

And as a final, but pivotal, side-effect, growth in life forms tends to produce *species* and at the same time the *exploitative relations* linking these species.<sup>30</sup> While the rate of growth of one species might be advanced by slowing down growth of the exploited species, feedback enhancing the growth of both eventually is possible. In other words, exploitation is a dynamic concept measurable over well-defined historic time spans.<sup>31</sup> Recaptured from this perspective, the most advanced form of money, the universally applicable algorithm of capital, is just the abstract claim of social value to grow. The ways that such a growth of social value can take are not limited to the development of new forms of exploitation across and within species.<sup>32</sup> To explore in which sense omnipresent capital processes can be superseded, which features might survive and which elements will have to be replaced rather rapidly, goes a bit beyond the scope of this paper—though the concluding section will come back to this issue.

With all these deficiencies, the new microeconomic view at the turn of the century—though an apt ideological vehicle to attract a considerable part of the intellectual elite—was unable to grasp the two most important processes going on in actual economic development: *technical progress and institutional evolution*.

To understand the former, it would have been necessary to treat capitalist production units as exploitation maximizing enterprises, and not just traders of the resources they own, forced to low prices by competitive markets. With the same

<sup>29</sup> While the Second Law certainly has the aspiration of an eternal truth, the stochastic character of that truth implies that temporary counter-movements can occur. This in turn implies that such a build-up of neg-entropy has a beginning and an end—carriers of life necessarily are born at a point in time and die after a finite amount of physical time.

<sup>30</sup> As with the simultaneous emergence of bankers and merchants on the one hand, and their relationship (credit-money) on the other hand, emergence of different species and their relations to each other are one and the same process.

<sup>31</sup> For a more detailed treatment of this idea, compare (Hanappi 2006).

<sup>32</sup> For the human species forms of exploitation of nature are usually combined with forms of the exploitation of one class of society by another class of society, of man by man. Since even in biology borderlines between species are hard to determine genetically, exploitative social relations play a central role for the structure between and within species. But note that exploitation, and thus class, is a dynamic concept, subjected to evolution.

argument, it would have become clear that the emergence of new institutions—of the bourgeois class as well as of the newly emerging labor class<sup>33</sup>—was enforced by the contradictions between the different groups, the different classes.<sup>34</sup> The endogenous emergence of institutions stays out of reach for any theory that insists on the notions of the ‘representative household’ and the ‘representative firm’. But both developments—technical advance as well as institutional evolution—actually were extremely strong and had the profoundest feedback influence on the path of economic evolution.

Inadequate theory is bound to be faltering—at least in the long-run. When the Great Depression proved the assumption of the effortless final arrival at the paradise of free market interaction to be definitely wrong, critics of the received doctrine—which itself necessarily remained mute—had their say.<sup>35</sup> Schumpeter attacked the common wisdom of the economist profession by substituting the equilibrium of traders of resources by a diversity of active entrepreneurs eager to push markets out of equilibrium.<sup>36</sup> Keynes added the political institution of the nation state and an independent influence of money oriented behavioral traits, e.g. an independent investment function, to replace the scanty models of his teacher, Alfred Marshall.<sup>37</sup> Rudolf Hilferding, creatively extending some of Marx’s insights, went even further and tried to incorporate the latest development of capitalism—he insisted that, on the way towards more oligopolistic market structures, a new form of capital was emerging: finance capital.<sup>38</sup> The only Austrian Nobel prize laureate, Friedrich Hayek, critically and lucidly remarked: *‘What I complain of is not that this theory [the quantity theory of money] in its various forms has unduly usurped the central place in monetary theory, but that the point of view from which it springs is a positive hindrance to further progress. Not the least harmful effect of this particular theory is the present isolation of the theory of money from the main body of general economic theory.’* (Hayek 1931, p. 4).

These and other criticisms lead to a revival of ideas closer to classical political economy, and as a new departure within economic theory, it came with a new brand name: macroeconomics. In hindsight, it seems to be rather obvious that it never really developed into a common, generally accepted view synthesizing all essential aspects of twentieth century capitalism.<sup>39</sup> Despite the amazing theoretical progress in many specialized areas, no coherent set of theories able to describe the essential

<sup>33</sup> The strongest growth of labor union membership occurred just in the three decades before World War One.

<sup>34</sup> Institutions, therefore, typically can either be a vehicle serving as a focal point for one of the involved groups, or constituted as a (temporary) freeze of a compromise reached.

<sup>35</sup> In this respect, the current crisis shows the same characteristic.

<sup>36</sup> See e.g. (Schumpeter 1939).

<sup>37</sup> See (Keynes 1936).

<sup>38</sup> Compare (Hilferding 1910).

<sup>39</sup> Paul Samuelson’s vision (still a pupil of Schumpeter) of a ‘neoclassical synthesis’ remained a fragment in that respect—and later collapsed completely when the so-called ‘microfoundation of macroeconomics’ failed.

characteristics of the development of the world economy emerged. One reason might have been the extremely shaky course global political economy took in the twentieth century.<sup>40</sup> An overarching theoretical construct would have needed much more effort with respect to the two formerly mentioned blind spots of mainstream economic theory: technological progress and institutional evolution.

Macroeconomics as part of economics was firmly established and culminated in a widely accepted formalization of Keynes' central ideas provided by John Hicks: the IS-LM framework. There, the idea of the importance of state intervention degenerated to shifts of both schedules (IS and LM) in an output-interest rate diagram due to government action (fiscal or monetary policy). The idea that money processes should be intrinsically included in any model of a monetary economy was reduced to two theoretical innovations: (1) A money demand function, which not only included the traditional transaction cash motive but also demand for 'speculative purposes'; (2) an independent investment demand, which compared an expected internal rate of return with a prevailing market interest rate. Both arguments refer to the process of using credit-money to achieve growth and thus comply with the stage of capital.

An additional feature of Keynes' model—perhaps its most important property<sup>41</sup>—was that it revived an old idea going back to the school of Physiocrats in the eighteenth century.<sup>42</sup> In each year, within a closed geographical region, the total amount of money is bound to stay constant, but has to follow a certain circular flow mirroring the needs of different social classes in the course of the year. When in agricultural societies seed and harvest set the rhythm, the year was a natural beat for the whole economy. Keynes, as long as he looked only at flows, could suggest a similar scheme: If new systematic build-up of inventories occurs, then total output during a year has to be identical with total demand (both in money terms), and since the different uses that this demand is channeled to can be neatly structured, there emerges an additional modeling constraint.

It is remarkable how this simple amendment that linked aggregate supply and aggregate demand (both in monetary terms), together with Schumpeter's suggestion of disequilibrium dynamics, was able to stimulate a first wave of non-linear macrodynamics.<sup>43</sup> But unfortunately, Keynes' attitude to state behavioral rules

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<sup>40</sup> There are good reasons why the eminent historian Eric Hobsbawm has dubbed this century the "Age of Extremes", see (Hobsbawm 1996).

<sup>41</sup> One of the most important side-effects was the establishment of statistical offices, which in most advanced countries started to collect data along the lines of Keynes' circular flow variables. Economically relevant relationships were suddenly assumed to be found in the data collected rather than as innate properties of human brains.

<sup>42</sup> The leading figure of this school producing the famous *Tableau économique* was Francois Quesnay (Quesnay 1758).

<sup>43</sup> As Paul Krugman later correctly noted, Richard Goodwin, (Goodwin 1955)—another pupil of Schumpeter—was the champion of that movement. See (Krugman 1996, p. 63). Goodwin in his later work explicitly hinted at his intention to combine Marx's ideas with Keynesian modeling and insights of Schumpeter to contribute to what he called the MKS-tradition.



always with variables in real money terms, i.e. postulating that economic agents are always fully aware of inflation, prevented the early model-builders from taking seriously Schumpeter's warning that a well-developed banking system is pivotal for innovation. Macrodynamics of the 1940s and 1950s became a disappearing fashion.

Nevertheless, a more adequate picture of what essentially was happening in the long-run of capitalist development was in the air. Schumpeter, inspired by Nikolai Kondratiev,<sup>44</sup> proposed to single out innovations—and in the sequel, their drivers, the economic agents he called entrepreneurs—as the central elements of capitalist progress. The mechanics proposed by Schumpeter and Keynes in principle were quite clear and not too far away from the actual working of the system. It may be sketched as follows:

In repeated cycles, households save part of the money they earn, transfer it to banks, which in turn provide credit-money for entrepreneurs. Competitive markets force entrepreneurs not only to invest, but also to increase the labor productivity of existing production processes<sup>45</sup> and to introduce new products and services. The increased output emerging that way could either be added to the stocks of exploited profit in banks (hence the banks' central role in searching for promising entrepreneurs) or could be given to the ever more organized labor class to secure political stability as well as effective demand. Since these rather sophisticated dynamics surely look unstable, the capitalist state is necessarily intervening—either politically (Schumpeter's view) or economically (Keynes' view). This vision of the process flirts with Hegel's "List der Vernunft" as well as with Mandeville's "private vices to public virtues".<sup>46</sup> As entrepreneurs strive for maximum profit, the structural constraint of competition forces them to do something beneficial for the whole society; specifically, they drive innovation—and they usually are not aware of that fact. Above all, this view seems to be close to what Karl Marx seems to have envisaged as the historical mission of capitalism in his manifesto (Marx 1848).

Though not adequately formalized yet, the success of the system described in the Keynes-Schumpeter perspective would clearly be supported by empirical observation. The social contract implicit in this working of twentieth century advanced countries was extremely successful in increasing GDP per capita. Diagram 1 shows the data for 12 Western European countries<sup>47</sup> first collected by Angus Maddison (Maddison 2006). This shows the explosion of technical progress, which has to be explained by economic theory. Note that GDP is measured in real terms and that per capita GDP is based on total population, not on employment. Labor productivity would be based on employment and thus would show the more production process oriented development, whereas the line shown in Diagram 1 concerns the average welfare effect of technological advance.

<sup>44</sup> Compare (Kondratiev 1926).

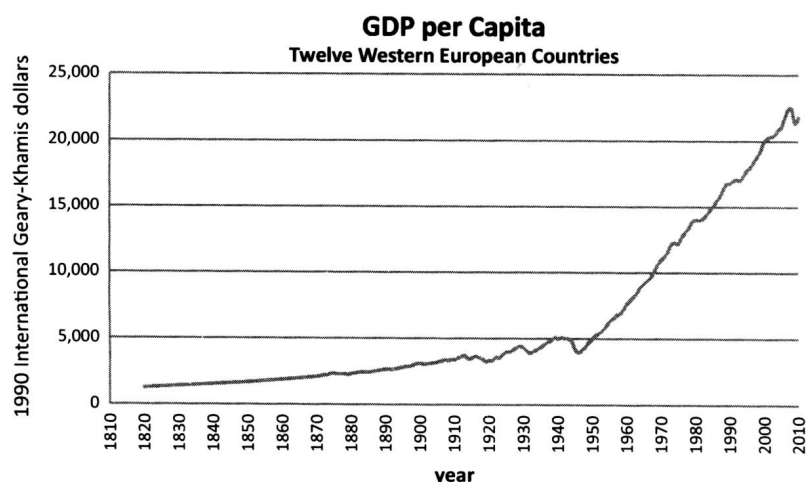
<sup>45</sup> A particularly interesting and recent empirical study of this link is (Ilyina and Samaniego 2009).

<sup>46</sup> See (Hegel 1807) and (Mandeville 1714).

<sup>47</sup> They originally were chosen due to data availability: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom.



**Diagram 1** Growth of  
GDP per Capita



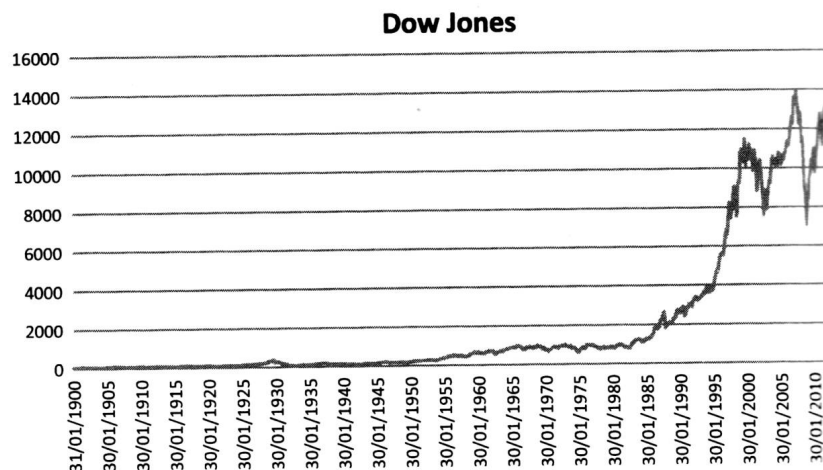
But Keynes' reintroduction of the cyclical character of economic activity, despite its merits, had crucial, even devastating short-comings. Instead of modeling accumulation and exploitation, his concentration on circular flows falls back on the counterfactual assumption of equilibrium. Keynes' *bon mot* that 'in the long-run we are all dead' hides the fact that his basic setup necessarily is restricted to short-run considerations—without any references to empirically observed analogies. As soon as medium-term developments appear, this setup collapses. The simplest case was taken care of by early growth models, e.g. the first one constructed by Keynes' colleague Roy Harrod.<sup>48</sup> The simple extension mainly concerned a definition: Capital is defined as the stock of accumulated net investment.

From the point of view of evolution of money forms argued so far, this is a serious misconception. While the amount of money signs in a given area certainly can be measured at well specified points in time, and an increase of that amount over time might be computed, this still remains measurement of money in its first form and cannot explain the role of credit and capital. Even nineteenth century classical political economy knew better when it coined the phrase 'madame la terre et monsieur le capital'. Land clearly was seen to be the passive factor of production; possible output was usually thought to be a little bit less than proportional to its extension. This is a far cry from the confusion occurring later when land—now called 'capital'—was assumed to have decreasing marginal returns. On the other hand, the active role of the classical 'monsieur le capital' vanished from the production function until Schumpeter let him in again as magically shifting functions due to his 'entrepreneurial spirits'. One of the most exciting tasks of evolutionary economics that still remains is to put more flesh on Schumpeter's sometimes rather naïve view of this innovation process. Above all, little has been achieved to further our understanding of capital as a process of the most developed *monetary* form. How important that is can again be grasped by a glance at Diagram 2 showing the long-run evolution of the Dow Jones index.

Since this index provides an evaluation of the most important corporations in the world performing the capital program, it reflects how successful capital works. Noteworthy is the great take-off that appears after 1982, and not immediately after

<sup>48</sup> Compare (Harrod 1939).

**Diagram 2** Dow Jones  
Index as a description of the  
success of capital



World War Two as in the previous Diagram 1. This highlights the two phases of accelerated accumulation: one immediately after the war, basically enhancing welfare, and a second phase from 1982 on, which left welfare on its old track but added substantial accumulation to the Dow Jones measure.<sup>49</sup> The economic interpretation of the two phases is straight forward: While Western Europe over the whole after-war-period until 2007 experienced a strong increase in economic power (power of population to produce GDP) and general welfare (GDP distributed to citizens)—everything on average—there is an additional upward push in the evaluation of the globally most relevant corporations since the beginning of the 80s. This second phase thus evidently coincides with the broad political roll-back to conservative economic policies in most OECD countries, Reagan in the USA, Thatcher in the UK, Kohl in Germany, and others.<sup>50</sup> Seen from the international perspective, this political switch, after a long-period of a catch-up race of Europe and Japan, heralded the somewhat surprising second wave of even stronger unchallenged US hegemony, culminating in the break-down of the Soviet Union in the early 90-ties.

Obviously, the working of capital on a global scale became even more strongly linked to political evolutions in this second phase than before. In the vision of most of mainstream economists even today, the discipline of economics concerns specific mechanisms (mostly market mechanisms) working in a vacuum of direct coercive power. All such power is thought to be monopolized in an anonymously governing political entity securing economic rules—and the study of this entity falls out of economists' concern since it is covered by political science. As argued above, this political entity never has been anonymous, but rather resides at the core of economics, providing its indispensable monetary authority. This monetary authority mainly comes in two forms: A guarantee of the *validity of the sign system*

<sup>49</sup> The DJI (industrial average) is the most widely accepted measure of capital activity with the longest historical time series.

<sup>50</sup> In a recent paper, this second phase also is characterized as a worldwide inflow of capital to US capital markets. Compare (Mendoza et al. 2009). It is accompanied by a relative shift of the US portfolio (as compared to other countries) towards more risky capital algorithms. Probably the stronger military stance of US policy enabled this shift.

*representing social value*, and the *provision and adaption of the rules of the economic games*. In particular, the second element neatly fits with the definition of capital put forward in this paper: It is the ensemble of the change of rules in nation states, the reframing of the program environment of the capital algorithms, which is responsible for the boom after 1982.

In other words, the long-run enhancement in labor productivity became superimposed by institutional evolutions initiating a new spurt of capital increasingly centered in the USA. Institutional settings became incredibly important for capital<sup>51</sup>; in short, an old player in classical political economy reentered the center of the stage: the state.

## 4 The State

Nation states in their new, non-feudal form are the institutional correlates to the evolution from credit-money to capital. Though in most countries the feudal class officially remained in power until World War One, the underground erosion of its influence started much earlier. When its rule finally broke, the world slipped into the deep troubles of the twentieth century,<sup>52</sup> which in retrospect can be understood as a search for new institutional solutions. The two remaining regimes, which—contrary to the fascist model—survived after WW2, were the new integrated capitalist state and the Stalinist production system.<sup>53</sup>

The development of institutional settings, as already mentioned in the previous section, is the second blind spot of mainstream economics today. It has received even less attention than technical progress. Of course, there is a fast growing literature discussing and describing the diversity of contemporary capitalism,<sup>54</sup> and even the implications of cultural and institutional diversity on decisions of transnational corporations have been extensively empirically studied.<sup>55</sup>

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<sup>51</sup> A good example is telecom firms for which the national regulations of a country are the most important influence on profits. More generally, transnational corporations' success critically hinges on using different national regulations for labor market regimes and tax regimes.

<sup>52</sup> A second look at Diagram 1 reveals that these troubles also materialized as welfare losses: World War One, the Great Depression, and World War Two.

<sup>53</sup> Compare (Hanappi 1994, pp. 103–162) for a more detailed description of the latter.

<sup>54</sup> An interesting comparative study of five types of contemporary capitalism was presented by Bruno Amable (Amable 2003). For a survey of issues related to that variety, see (Elsner and Hanappi 2008).

<sup>55</sup> Some of the most promising contributions come from a group of Dutch economists, who originally tried to nail down the theoretical framework of New Economic Geography to answer empirical questions of spatial economic policy. See (Brakman et al. 2007, pp. 267–405). Another good example of empirically interesting conclusions with respect to firm evolution is (Lechevalier 2007).

Nevertheless *the evolution of this diversity* has not been conceptually particularly convincing. There has been some effort to collect different perspectives from heterodox economics, see e.g. (Hodgson et al. 2001), but a synthesizing approach still seems to be out of reach.

It is not surprising that attempts to conceptual institutional evolution along the lines of Darwin's ideas on biological evolution of the human species emerged early on, with Herbert Spencer readily introducing the analogy between biological selection and survival in competitive economic markets.<sup>56</sup> A thorough discussion of the issues surrounding 'Social Darwinism' and the role it played for fascism would go beyond the scope of this paper, it is nevertheless evident that, after WW2, the misuse of Darwin's concepts through fascist propaganda let social scientists shy away from direct applications of biological concepts to social developments. In retrospect, not much has been lost by the neglect of these early developments. The evolution of institutional settings was not in the focus of social Darwinism anyway, Spencer's atomistic view (nineteenth century market liberalism) had been substituted by archaic, hierarchical systems with little or no explanatory force.

What actually happened in institutional structures since 1945 is, above all, *a strong trend towards more continental political entities*, the emergence of continental units. Though there is considerable change in the list of nation states, too,<sup>57</sup> the social innovation of the last 60 years clearly has been 'continental units in a common global context'. The most remarkable institutional social innovations date back to the early years of that era: the World Bank, the IMF, WTO (former GATTs), and the UN. Note that one important international rule system did not survive the early 1970s and thus is a good candidate for the explanation of the following discontinuity in 1982: The Bretton Woods system of fixed exchange rates.<sup>58</sup>

After the turbulent institutional attempts in the war and peace periods of the first half of the twentieth century, the second half saw the fading away of the Stalinist production system of the Soviet Union until the 1990s, and more recently the flourishing of a modified variant of this system in China. These basic breaks in global political economy set the frame for the institutional variants accommodating capital in the Western world since 1992. In particular, the evolution of financial institutions since that point in time can reveal interesting insights.

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<sup>56</sup> See (Spencer 1862), a contemporary and rival of Darwin, who combines his evolutionism with the strict market liberalism [against any state intervention, (Spencer 1884)] so typical for aristocratic scientists of the nineteenth century.

<sup>57</sup> Compare (Radax et al. 2009).

<sup>58</sup> It is tempting to interpret the second phase, which is so dominant in Diagram 2, as being based on 'exploitation via flexible exchange rates in a globalizing world of TNCs'. The success of capital on a global scale in this second phase contrasted by only continuous growth in Diagram 1 (average GDP per capita) translates into an opening spread of incomes: Those derived from these global successes explode, while those (in Western Europe) which were not had to grow slower than before 1982 to arrive at the continuity shown in Diagram 1.



From an evolutionary perspective, such an investigation should take account of a too simplistic analogy, a mistake to be found in the concluding chapter of the economic historian Niall Ferguson's recent book (Ferguson 2008, pp. 341–358):

*“Financial history is essentially the result of institutional mutation and natural selection. Random ‘drift’ (innovations/mutations that are not promoted by natural selection, but just happen) and ‘flow’ (innovations/mutations that are caused when, say, American practices are adopted by Chinese banks) play a part. There can also be ‘co-evolution’, when different financial species work and adapt together (like hedge funds and their prime brokers). But market selection is the main driver. Financial organisms are in competition with one another for finite resources. At certain times and in certain places, certain species may become dominant. But innovations by competitor species, or the emergence of altogether new species, prevent any permanent hierarchy or monoculture from emerging. Broadly speaking, the law of the survival of the fittest applies. Institutions with a ‘selfish gene’ that is good at self-replication and self-perpetuation will tend to proliferate and endure.”* (Ferguson 2008, pp. 350–351)

Though it might be a kind of excuse that the text was written in May 2008, when the full extent of the looming crisis of finance institutions was not yet visible, it nevertheless is a timeless example of undue transplantation of biological metaphors. Financial institutions are not born by simple ‘innovation/mutation’; they are strongly linked to the regulatory rule system of the nation states and thus are shaped in a way that reflects the surrounding political entity. The death of these finance institutions usually is not caused by competitive rivals in markets for ‘scarce resources’. It rather needs a complex procedure—including several political entities sometimes, from state agencies to unions—to allow a large financial intermediary to go bankrupt. Finally, Richard Dawkins’ suggestion<sup>59</sup> to re-introduce a moral concept, selfishness (remember Mandeville’s ‘vices’), does not lead to a better understanding of the performance of financial institutions—to say the least.

As argued in this paper, instead of unwise direct use of concepts of evolutionary biology, the evolution from money to capital is a process that evolutionary economics has to explain as an indispensable part of the economic evolution in general, of monetary political economy. The two important trajectories shaping the last 200 years of capital were technological progress and institutional evolution, and it is in the light of their development that financial institutions have to be understood. The evolution of the state, again, is a rather big topic; only a selected range of issues can be mentioned here.

The ‘state’ today comes mainly in three formats<sup>60</sup>: As nation state, as continental unit, and as a globally governing political unit. In the USA and in most parts of the EU, the elementary money form (US Dollar, Euro) is provided at the continental level, in Asia, such a unit is still in the making. The most developed form, the

<sup>59</sup> Compare (Dawkins 1989), and see (Lewontin et al. 1984) for a critique of Dawkins’ attempt to extend biological metaphors to the social sciences.

<sup>60</sup> The focus on these three formats is due to the emphasis on the state’s role as a monetary authority. A broader approach centering on the many ideological tasks the state takes care of can be found in (Althusser 1970).



capital algorithm, in principle works on the global level, though the level of regulations for most rules is the national level. Financial institutions carrying and executing the regulations are to be found on all three levels, and there is a trend to move power to the upper levels, leaving smaller tasks to subsidiary lower levels.

With respect to the existence of respective political bodies, their evolution on all three levels, and in particular towards the highest level, entered a hot phase since 1982. The emergence of the EU is a very recent development, a similar entity uniting China, Japan, and India has not even started—not to speak of the global level. In each of these institutional evolutions, specific history and culture of the concerned area—formally spoken: foregone path dependency—play a crucial role. As a consequence, *evolutionary economics has to revive its history component* to understand better current options and possible future trajectories of institutional evolution. In a sense, the current general crisis is just a symptom of the mismatch of the available institutional carrier systems and the capital program of large scale private carriers. Given this interpretation, the depth of the crisis is not surprising—hopefully it *gives birth to a new global institutional design*. Many current proposals of singular adjustments of some rules of the prevailing financial architecture (e.g. Basel 3) miss this point and will prove as useless as will be the desperate conjurations of ethical behavior of capital managers. This crisis is *not* about the misbehavior of individual physical persons.

What has to fit a new global institutional setting is a worldwide *structure of production units*, a structure that builds on (and partly transforms) the existing structure.<sup>61</sup> The separation of functions between globally acting TNCs and local SMEs, the main providers of employment, is already taking place.<sup>62</sup> The original role of the banking system in the twentieth century—namely, to discover the most profitable routes for further capital expansion and to channel credit towards these investments—has stagnated in the last 2 decades. Profitable intrusion of new spaces for investment became difficult. Indeed, the financial hype after the IT bubble in 2001 was built with the help of self-fulfilling prophecies, which needed *not* to be grounded on actually existing expectations concerning profitable real investment<sup>63</sup>—simply because such possibilities became extremely rare. It is thus a logical consequence that the mismatch between the most advanced money form (the capital program) and its welfare enhancing ‘historical mission’ first made its appearance as the fall of a carrier system of that mission, the fall of a large financial institution, the fall of Lehman Brothers on September 15, 2008.

Immediately after this pivotal turn, the role of state intervention—on all three levels and in content contrary to almost all policy discussion since 1982—was

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<sup>61</sup> The contemporary interaction between TNCs and nation states concentrates on choice of capital structure of the former given ‘political risks’ set by the latter, as empirically studied by e.g. (Kesternich and Schnitzer 2009).

<sup>62</sup> In a recent contribution, this development of global firm structure and its connection to global mega-cities is discussed in more detail (Hanappi 2009).

<sup>63</sup> A more theoretical companion paper to this paper discusses four reasons for the financial crisis in more detail (Hanappi and Rengs 2008).

suddenly on the agenda again.<sup>64</sup> Since then, the debate more and more concentrated on the question of where and how the state should intervene, and if it should intervene at all was discussed less and less. But if the necessity for the state's active role is taken for granted, then the next questions are for the type of intervention and for quality and democratic control of the state's decision makers (again at all three levels). But these questions are nothing other than the above mentioned call for the design of a desirable institutional setting.

## 5 Some Policy Conclusions

Any policy conclusion—in particular in critical situations—rests on a vision of possible future developments, in a less mundane language: on forecasts. Forecasts in times of deep crisis need a far reaching interpretation of the past (e.g. the one given in the previous sections of this paper) as well as some empirical evaluation of what was just happening in the immediate past. There exists an impressive flood of descriptions concerning the latter<sup>65</sup>; Diagram 3 just shows the recent development of the Dow Jones Index.

To make sure that this rather dramatic short-run development in the world's stock exchanges is not just the usual working of these markets necessary to clean it from unsound expectations, take a look at the long-run, real GDP growth rates of the USA, Germany, Austria and the four next largest countries of the Eurozone (France, Italy, Spain, UK) in Diagram 4.

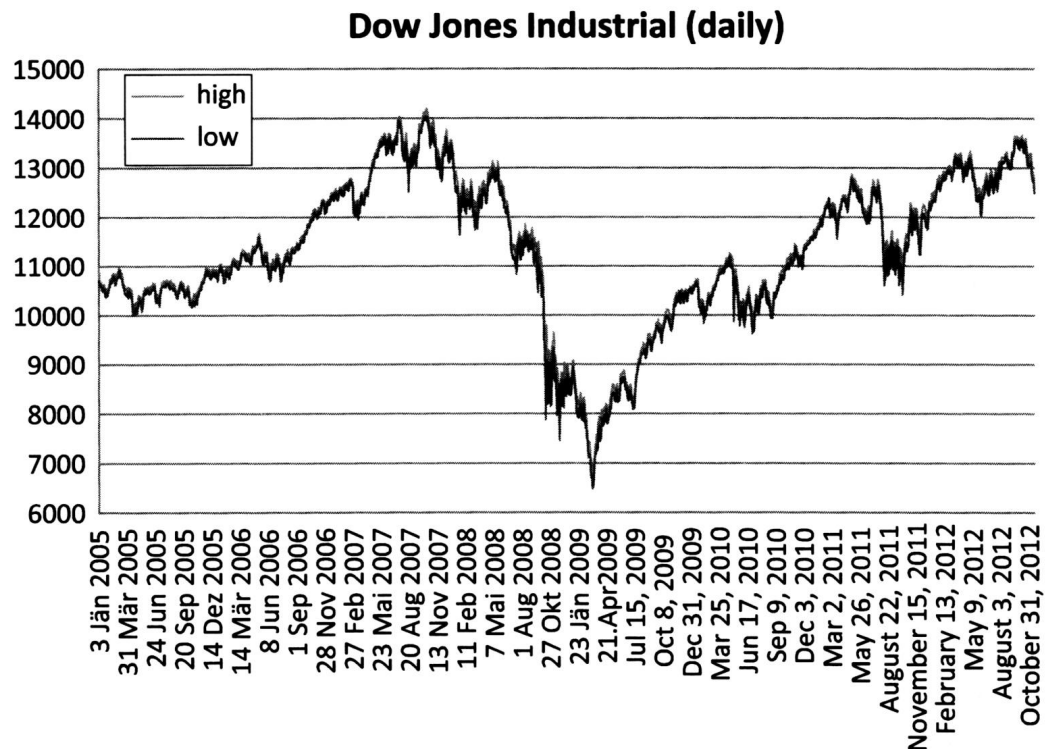
As the diagram shows, there can be no doubt that this is the worst crisis for output and employment in the world since the Great Depression. According to our (continuously improved but always preliminary) forecasts, the worst is still to come: The fall in employment has hit all countries and there is no prospect for recovery.<sup>66</sup> How far average household incomes did fall due to this employment crunch depended heavily on the incomes policy of the respective nation state. By subsidizing wages and supporting private and semi-private financial intermediaries (e.g. banks and insurance companies), many countries translated the global crisis into a national public debt crisis. Given these measures, most European households were able to keep consumption at only slowly decreasing levels—using up their savings and credit worthiness. But then, starting with the case of Greece, international short-run speculation discovered the use of large scale profit rate expectations derived from producing information about possible public debt default of a country.

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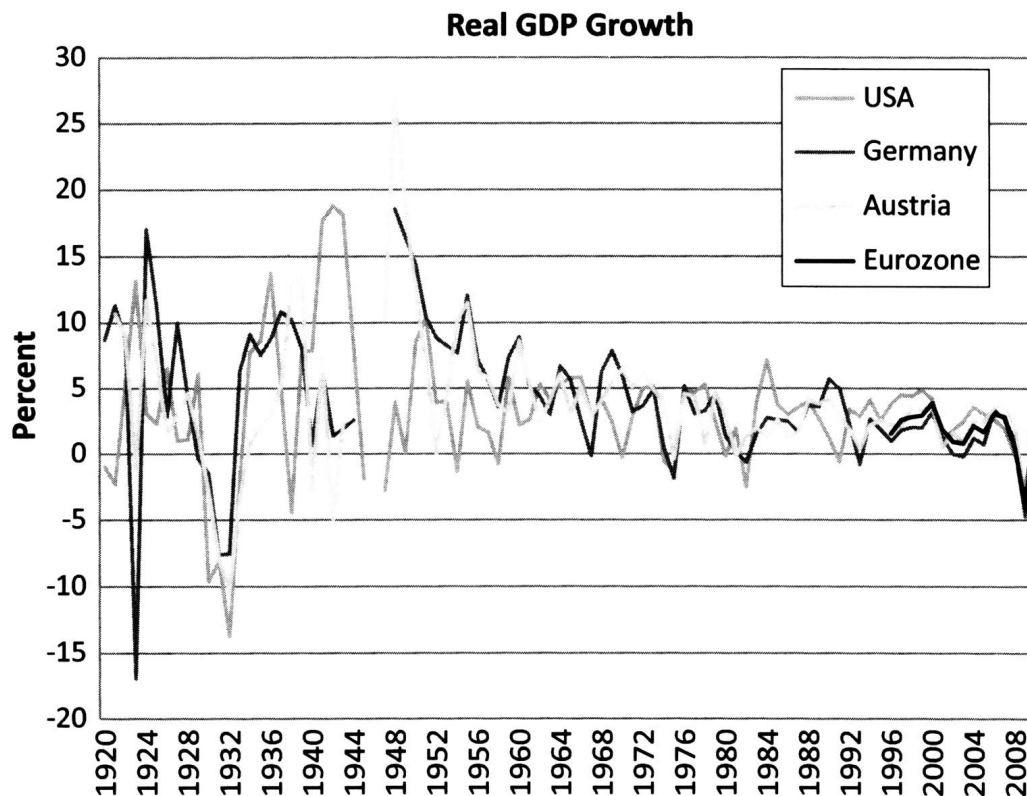
<sup>64</sup> As a recent contribution, compare (Auerback 2009).

<sup>65</sup> One of the most informative papers is (Calomiris 2008), a survey of events is (Furceri and Mourougane 2009).

<sup>66</sup> See (Wray 2009) for an appraisal of the importance of avoiding high mass unemployment. Martin Shubik, in a similar vein, suggests social innovation in the form of a 'Federal Employment Reserve Authority' Compare (Shubik 2009).



**Diagram 3** Dow Jones Index (daily) as a description of recent events



**Diagram 4** Growth rates of real GDP

In the last years, this new game of international finance gained momentum, spreading to all Mediterranean countries and Ireland, and called into question the very existence of the European Union. Indeed the EU seems to be at the crossroads: Either it falls prey to the global capital program, which aims at restoring

profitability in the weakest parts of the European country chain by re-introducing exploitation standards which European citizens today only know from TV-programs about less developed parts of the world. Or Europe unites and constitutes itself in a much more stringent and consistent way, as currently is the case. To avoid European disintegration, a close look at the reasons for disintegrative forces, an analysis of the emerging contradictions, will be the first necessary step. This immediately leads to the incompatibility of the globally working finance capital program and full employment in Europe.<sup>67</sup> To some extent, the notion of full employment might be redefined by reforming labor time organization. But still many questions remain: How can European public political institutions be implemented, which can secure the existing welfare standard at a zero growth rate? What can be the position of European economic activity in the global division of labor? If political institutions are not forced to grow—and to pay interest—the new monetary regime in Europe must still be made compatible to the global financial architecture. Add the even more burning question that the chain reactions of the global crisis are finding other weak chains in the highly interdependent global political economy with accelerating speed, the upheaval in the Arab countries is just the latest outstanding example.

In that situation, social and political pressure on policy makers already is enormous. This might enhance the efforts to develop and to implement a new institutional setting on a global level. But it also is an extremely dangerous transition period—comparable in some respect to the 1930s of the last century—since the history-dependent national responses to such a crisis easily can lead to locally dangerous phenomena, to governments based on direct coercive power instead of democracy.<sup>68</sup> The availability of highly efficient military means makes such a threat indeed more threatening than ever.

But even if it is possible to avoid the worst,<sup>69</sup> there will be no return to a smooth working of the old capital algorithm with high profit rates. Indeed the two big bubbles (ITC and finance) at the beginning of the century showed that the recent surge of 5 boom years had been built on thin air. Of course, the omnipresent capital program will not vanish, but it will lose its dominant role, and in most advanced OECD countries will have to be content with very low accumulation rates. No contemporary TNC can be imagined that can keep its organizational structure and culture with such a low profit rate. So the global setup of firms, of production units, will have to change profoundly. The lower turning point leading to this mild

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<sup>67</sup> Some more sanguine politicians still express their pointless hope for an automatic reconciliation of this contradiction as their 'hope for growth'.

<sup>68</sup> Therefore, a sophisticated regulatory response of institutions on the national level, tailored to the respective situation, is particularly important. This, of course, includes financial institutions; see (Nier 2009).

<sup>69</sup> Olivier Blanchard suggests a set of Keynes-style, demand-oriented measures to fight the crisis; Barry Eichengreen concentrates on regulatory remedies engineered by a reformed IMF; see (Blanchard et al. 2008) and (Eichengreen 2009). An alternative (even more 'Keynesian') interpretation and proposal for a policy recipe is provided by Jan Kregel (Kregel 2009).



recovery might be reached in 2015, so reorganization should start within the mid-term planning horizon of large firms. But there will be some firms winning, at least in terms of market shares of the shrinking market, and they will be hard to convince to accept new global political rules.

In several other aspects, a return to direct political measures can be expected, too. To secure a sustainable level of employment labor time regimes will be adjusted rather quickly—short time work will be here to stay and solutions tailored to the needs of production units and households hopefully will be found. Direct employment as state employees will start to play the important role of an immediate remedy. Since all this increases government expenditure, the question of who is lending to the government has become virulent. If the crisis is global, the traditional banking sector will not be able to step in and a partial return to measures reminiscent of command economies—perhaps including a moratorium on public debts in the USA and Europe—will be inevitable. As in wartime, a war against unemployment lead and ‘financed’ by governments might be a preferable solution.

With respect to money, this highly speculative outlook strongly points to a new metamorphosis of the money form. As was the case with previous form changes, the new form will *not* simply replace the current one; it rather will superimpose new and dominant features.<sup>70</sup> These features will have to be able to solve the most pressing problems of the global human species in the new century. The global character of these bottlenecks clearly calls for a large scale political decision procedure—democracy at work—carried out and executed by highly professional and committed agencies.

Global economic policy will have to work along the lines of the respective next bottleneck. The major three problem areas to be solved next—the new ‘historical mission’ of the new money forms following the capital algorithm—could be:

- (1) Solving the question of avoiding a fallback to regimes of direct coercive power
- (2) Solving the questions of sustainable environmental conditions
- (3) Solving the questions of increasing income and wealth inequality in the world

Channeling economic and political activity towards work solving these problems will again be a program rather than a simple sign system of social values. It will even be a more complicated program than the capital algorithm residing in business plans and psychological traits of humans today. As a top-down program, it will need not only conscious planning but even planning of consciousness of the society as a whole. It thus will be a new experience for mankind. Money, the materialized expression of social value, on its long journey to ever greater abstraction, will start to become intentional on a global, social scale. Technical progress

<sup>70</sup> This, of course, is also true for technical innovation proper, for new products and processes. Technical innovation will go on, but the newly dominating form of reproductive innovation—out of need—will be more and more *social innovation*. Technological innovation will turn towards *change* of products and processes, capital *growth* as a motive for innovation will fade out. The entrepreneur as social entity will be transformed along these lines.



has already produced the preconditions<sup>71</sup>; institutional evolution—indeed the implementation of adequate mechanisms of democracy—is knocking at the door of scientists, of evolutionary economists, to complete a synthesizing vision for this century.<sup>72</sup>

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<sup>71</sup> In a large research project for the Austrian National Bank, the technological impact on money forms has been studied (Hanappi 1999).

<sup>72</sup> It is encouraging that the Nobel prize in 2009 was given to Elinor Ostrom, whose major contributions—contrary to many journalists' perceptions—concern the 'understanding of institutional diversity' (Ostrom 2005).

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Guido Buenstorf • Uwe Cantner  
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Hans-Walter Lorenz • Fritz Rahmeyer  
Editors

# The Two Sides of Innovation

Creation and Destruction in the Evolution  
of Capitalist Economies

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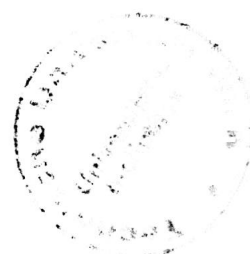
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# Contents

<b>Editorial: The Two Sides of Innovation</b> . . . . .	1
Guido Buenstorf, Uwe Cantner, Horst Hanusch, Michael Hutter, Hans-Walter Lorenz, and Fritz Rahmeyer	
<b>Part I Innovation: Conditions to Successfully Create Novelty for Economic Development</b>	
<b>Agents of Change</b> . . . . .	11
Caroline Gerschlager	
<b>Network Evolution in Basic Science</b> . . . . .	39
Thomas Grebel	
<b>Inventor Networks in Emerging Key Technologies: Information Technology vs. Semiconductors</b> . . . . .	55
Holger Graf	
<b>Not Invented Here: Technology Licensing, Knowledge Transfer and Innovation Based on Public Research</b> . . . . .	77
Guido Buenstorf and Matthias Geissler	
<b>Innovation in the Age of the Fuggers</b> . . . . .	109
Rolf Walter and Maximilian Kalus	
<b>Part II Innovation: Induced Structural Change, Coping and Normative Assessment</b>	
<b>Agent-Based Modelling of Novelty Creating Behavior and Sectoral Growth Effects—Linking the Creative and the Destructive Side of Innovation</b> . . . . .	129
Frank Beckenbach, Maria Daskalakis, and David Hofmann	
<b>Creative Production in the Creative Industries</b> . . . . .	159
Michael Hutter	

<b>Labor Market Integration Policies and The Convergence of Regions: The Role of Skills and Technology Diffusion . . . . .</b>	<b>167</b>
Herbert Dawid, Simon Gemkow, Philipp Harting, and Michael Neugart	
<b>Creative Destruction and Fiscal Institutions: A Long-Run Case Study of Three Regions . . . . .</b>	<b>187</b>
Lars P. Feld, Jan Schnellenbach, and Thushyanthan Baskaran	
<b>Is Novelty Always a Good Thing? Towards an Evolutionary Welfare Economics . . . . .</b>	<b>209</b>
Christian Schubert	
<b>Part III Innovation and the Evolution of Capitalism</b>	
<b>Dynamic Circular Flow Models with Innovations . . . . .</b>	<b>245</b>
Adolf Wagner	
<b>Money, Credit, Capital and the State . . . . .</b>	<b>255</b>
Hardy Hanappi	
<b>Asymmetric Markets and the Evolution of the Division of Labor . . . . .</b>	<b>283</b>
Carl Christian von Weizsäcker	
<b>Recent Developments in Evolutionary Biology and Their Relevance for Evolutionary Economics . . . . .</b>	<b>291</b>
Karin Knottenbauer	