



## Peter Burgess LinkedIn Blogs

### What is Capital?

People talk about 'preserving capital' and 'capitalism', but what actually is capital, especially financial capital?

When I think about how the economy works, I think in terms of 'state' and 'flows'. This is consistent with much of physics and natural law, and is also consistent with the way double entry accounting works.

Capital is part of 'state' ... and putting capital to work is part of 'flow'

In accounting, there is also the idea of a 'capital expenditure' which is an expenditure for something that has a long life and will be part of the balance sheet or 'state' of the company. This contrasts with the 'working capital' which are balance sheet items that are needed, but turn over quite quickly as the business operates ... that is inventory, accounts receivable, and some cash.

In economics, people talk about factors of production. Capital is one of these. The others are land and labor. Capital in this context is financial capital. I would argue, however, that while this construct was reasonable when it was first described in the 18th century, it no longer explains the functioning of the modern economy very well. Something more is needed.

If we think of capital as being all of the various components of the balance sheet of society in the broadest possible sense, it becomes relatively easy to understand socio-economic progress and also to measure the performance or efficiency of the system. But in this case, capital is not only financial capital but all the other capital 'things' that are part of the system.

As well as financial capital, there are also human capital, social capital, physical capital, institutional capital, cultural capital, intellectual capital and natural capital. Natural capital includes resources like land, water, minerals, fossil fuels, biological systems ... everything that comprises the natural bounty of the planet.

In modern financial analytics, a value may be included in the present balance sheet that reflects anticipated future financial flows. When this is applied to the broader balance sheet of society and the economy, there is the present value of the future energy flows associated with solar energy hitting the planet. As a practical matter, we do not know how to make use of this energy efficiently, but as our intellectual capital increases, so also will the value of this flow of solar energy.

Over the past three decades there has been an increasing amount of conversation about the 'post industrial era' and the 'knowledge economy'. I see this as a discussion about 'intellectual capital' and the role intellectual capital should be playing in the functioning of a high performance modern economy. Intellectual capital is key to improving the performance of almost everything, and, of course, this is recognized in the modern economy by the way intellectual capital is

manipulated to become 'intellectual property' and then more easily 'monetized'. I see intellectual capital as being of great importance simply because it is a limiting constraint on what humankind can accomplish, and it is also something that is limited by what people choose to do with their brains.

Physical capital includes all of the built environment, buildings and infrastructure and the physical things like cars, trains and ships, machinery and equipment in factories, and everything else that is used to make the economy function. Physical capital makes a huge difference in the way an economy performs, and in turn this is reflected in the quality of life that becomes possible.

Institutional capital includes all of the 'soft' structures that allow the economy to function including the institutions of government, the systems of law and justice, the organizations that carry out economic activities, and so on. Freedom and liberty are possible because of institutional capital.

Cultural capital is also 'soft' but important. Quality of life is enhanced when there is substantial cultural capital, whether it is in the capacity to perform and enjoy music, dance, art and so forth, or whether it relates to the traditions and history of a community.

Natural capital has been a key to economic performance in all of history, and land was included as one of the factors of production in early economics. In the more complex modern economic and social system all the components of natural capital need to be included in the framework for modern social and economic analysis. In general, economic activities use / deplete natural resources and cause environmental degradation in many different forms.

Natural capital comprises many different and very complex systems ... but essential for absolutely everything. For most of human history economic activity was small relative to natural capital, but this has changed fast over the last two or three hundred years, and now it is clear that economic activity has the potential to deplete natural capital on a massive scale. We are unsure about the aggregate impact of depletion of natural capital, but even a superficial study of business and economic history suggests that industrial scale business activity has the capacity to do immense ecological damage in a very short space of time.

I argue that the ultimate purpose of economic activity is to enhance human capital, that is to have a human population that has a decent quality of life and standard of living. A high performance economy is one where this is achieved with little or no damage to natural capital, and little or no diminution of all the other capitals.

Social capital differs from human capital in the sense that human capital is about an individual, whereas social capital is about a community of individuals and the way the group may not simply be the sum of the individuals. A friendly society can enhance the quality of life of the individual, and in the other direction, an anti-social individual can have an impact on society and others. What makes people happy is not obvious ... and not linear.

In the end financial capital is more a measure than a reality, but what does it measure. For every unit of money wealth, there really ought to be some other capital that is the backing for the money denominated security ... as for example an Asset Backed Security (ABS). Indeed, money itself is a construct with no real backing.

In the end financial capital is a measure of the 'ownership' of these other capitals and in this context the role of people and their quality of life is totally discounted. This is problematic and

should be addressed. Conventional accounting and economic and financial analysis does not incorporate the analysis of the 'state' and 'flows' of all the capitals ... but a system of metrics that does this would enable an optimization of resource use that could make society and the economic system function in a more efficient manner than it has demonstrated over the last 50 years.

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