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The Culture of Modern Capitalism

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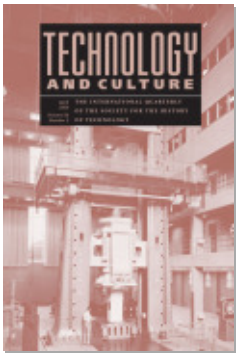

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ESSAY REVIEWS

The Culture of Modern Capitalism

Robert B. Reich, *Supercapitalism*
Raghuram G. Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists*
William J. Baumol, Robert E. Litan, and Carl J. Schramm, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity*

JOEL MOKYR

As I write, industrial capitalism is undergoing its worst crisis since the Great Depression, possibly a crisis that may become the worst ever. Though completed before the current financial situation exploded, these three books all point to a variety of vulnerabilities in the world capitalist system in the first decade of the third millennium.[1] All three volumes under review here share a basic philosophy: Capitalism is the most open, creative, and dynamic economic system ever devised, and for over two centuries it has been successful in generating a long and sustained period of technology-driven economic growth, in the course of which a large and growing portion of humanity reached living standards beyond the wildest dreams of anyone alive even during the Industrial Revolution of the eighteenth century. But capitalism must always and everywhere be understood in a political context, because there never was or will be a politics-free system of markets and production, and politics remains central to capitalism's development

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1. Robert B. Reich, *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life* (New York: Alfred A. Knopf, 2007, pp. ix+272, $25); Raghuram G. Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity* (Princeton, N.J.: Princeton University Press, 2004, pp. 392, $25.95); and William J. Baumol, Robert E. Litan, and Carl J. Schramm, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity* (New Haven, Conn.: Yale University Press, 2007, pp. 336, $30).

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and survival. At some point in the 1970s or early 1980s, the capitalist system changed quite dramatically. Whether that change made the current crisis in some sense inevitable remains to be seen, but it did make it more likely.

The books reviewed here are written by distinguished academics and policy specialists, scholars who know and understand the system as well as it can be understood. None of them comes from a Marxist or radical tradition that finds capitalism inherently distasteful or inhuman. They are, if anything, more in the tradition of John Maynard Keynes, who recognized the flaws and weaknesses of capitalism and showed how to fix it and make it work better rather than seeking to overthrow it.

Of the authors, Robert Reich is certainly the best known, both to those who recall the Clinton administration's pugnacious and lively secretary of labor and to those who listen obsessively to the *commentariat* on NPR airwaves. Reich's erudition and wit shine through and show why he has become one of the more influential public intellectuals on the medium-left wing of the Democratic Party. His historical model works as follows. After the Depression and World War II, American capitalism was characterized by powerful oligopolies that were huge, secure, and profitable. They kept out competitors through a combination of economies of scale, government regulation, and other devices. Yet their power and income were tempered by democratic institutions, which kept marginal taxes high, executive salaries reasonable, real wages and benefits high, and consumers and workers protected from their worst excesses. It was the age of "democratic capitalism," and all was well.

This nice and peaceful equilibrium, in Reich's account, was rudely shocked by technology. Cold war and space-race R&D led to technological changes in the 1970s and 1980s that reduced the power of these oligopolies. A cozy competition that was more symbolic than real evolved into "supercapitalism"—a cutthroat world in which much freer entry of start-up firms and competition from foreign firms upset the status quo. This competition took place at a variety of levels, including labor and capital markets as well as jockeying for position in the regulatory world. Profit margins became thin, and vulnerable firms, no matter how large, were forced to engage in a variety of practices that they would once have found objectionable. As Reich writes, "companies under supercapitalism no longer have the discretion to be virtuous" (p. 173). What evolved is a kind of firm behavior many associate with Wal-Mart—ruthless employment policies, irresponsible environmental attitudes, merciless squeezing of suppliers, disregard for communities and aesthetic values, immoral manipulation of political power. Everything is now sacrificed for lower prices, and lower prices are the key to survival.

Reich does not take an indignant stance toward Wal-Martism. These firms do, he explains, what they are supposed to do. Any means for seeking

a competitive advantage, however fleeting, must be deployed, including the aggressive lobbying of politicians and regulatory agencies. Even highly successful and profitable corporations are under the gun, because shareholders will respond immediately to any perceived change in the firm's prospects. As a result, the political system in the past two or three decades has had less and less power and incentive to regulate, redistribute, inspect, and protect. Consequently, politics has lost its ability to temper the worst excesses of capitalism as it did in the 1950s and 1960s. Income distribution has become more unequal because tighter competition has depressed wages and caused firms to hire cheaper labor, at home and abroad. Unions have lost much of their influence, as they are a luxury that firms can no longer afford. Superstar CEOs who promise to give the firm a marginal competitive advantage are pursued vigorously, and competition for the very best drives up their salaries. The same mechanism that has driven up the salaries of top baseball players in the equally competitive world of Major League Baseball is at work here.

If cutthroat competition has become as severe as Reich claims, one testable prediction is that firms would have become less profitable. In a highly competitive world with easy entry, as economists have taught for generations and Reich full-well knows, excess profits and the returns on entrepreneurship would fall. Moreover, as the government regulated less, the exclusionary rents (in practice hard to distinguish from profits) that firms enjoy should come under pressure. In reality, however, the profitability of American corporations seems not to have declined since the 1960s. In 1970, at the peak of the golden age of "democratic capitalism," the U.S. corporate non-farm sector earned an average of about $65 billion in profits, or 7 percent of gross domestic product, while in 2006 it generated slightly under a trillion a year, or 8.5 percent of GDP.[2]

This is not the whole story: as Reich points out, there certainly has been more turnover among the largest firms, which renders their environment more uncertain. Some venerable corporate giants of 1970 have either disappeared or are in imminent danger of doing so. This points to a tighter competitive world. At the same time, however, growing "economic profits" were paid out as bonuses and stock options to top executives, which would bias the estimate of profits coming from "proprietor's income" downward. An executive earning $50 million a year does not receive a "competitive wage" but effectively shares in the profits of the firm. If that gets counted as "labor income," too bad for national income accounting. Perhaps, then, the age of supercapitalism is more than the rise of cutthroat competition.

Reich argues that under supercapitalism Americans have gained power as consumers and investors and lost it as workers, citizens, and voters.

2. *Economic Report of the President: 2008 Report Spreadsheet Tables*, at http://www.gpoaccess.gov/eop/tables08.html (accessed 29 December 2008).

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Economic markets may not be the all-wise arbiters that some of their more enthusiastic supporters suppose, but political markets are a lot worse. Not only do they rarely deliver perfect outcomes, they normally perform quite miserably. But have things actually gotten a lot worse in the decades of supercapitalism? Reich's argument is that in the new highly competitive environment, large corporations have no choice but to spend large amounts on lobbying politicians and regulators to gain competitive advantage over some real or potential competitor. He notes (p. 134) that the number of registered lobbyists between 1975 and 2005 went up by a factor of ten, a chilling number. Yet consumer and environmental protection were essentially absent in the age of democratic capitalism, the age that produced *Unsafe at any Speed* and *Silent Spring*. Moreover, by his own account, the stakes of influencing the government seem to be relatively small precisely because supercapitalism takes place in an age of freer trade, deregulation, and slack enforcement of the few rules remaining on the books. Perhaps some of the answer to the question of why money (especially corporate money) plays a bigger role in politics today has to be sought elsewhere, on the demand side of political campaigns ever more thirsty for funds because they are engaged in a race to the bottom for survival in politics, and not just economic survival of corporate entities.

Raghuram G. Rajan and Luigi Zingales have a different take, at least in part. For them, the age of democratic capitalism—roughly the three decades the French call their *trente glorieuses* after 1945—was anything but a golden age. Governments in capitalist nations, under the constraints of Bretton Woods, strongly controlled domestic capital markets and foreign currency flows. Access to finance was mostly for insiders, people with connections to bankers or politicians. By limiting access to capital markets, incumbent firms before 1970 or so could control entry and establish a cozy "crony capitalism," or, as they like to call it, "relationship capitalism." This age, unlike Reich's picture, is painted by Rajan and Zingales in stark hues: it was one of technological stagnation, in which inept and incompetent managers bungled companies without fear of corporate takeovers, or foreign or local competition.

In the 1970s everything changed, but for Rajan and Zingales the source of change was not technological but institutional. Most industrialized countries liberalized their capital markets and started to remove rules and regulations that had prevented these markets from doing what they are supposed to do (as well as, some would add, a few things they were not supposed to).[3] Once international capital flows became a fact of life in the 1970s, domestic regulations on financial institutions were cast aside or rendered toothless. This marked the end of relationship capitalism. Competi-

3. A similar view was expressed earlier by Reuven Brenner, for example, in *The Financial Century: From Turmoil to Triumphs* (Toronto, 2001).

tion became tighter, new entry a realistic possibility, rapid growth of successful firms a routine, and corporate raiders armed with junk bonds and private equity funds hunted with eagle's eyes for weak managers and complacent corporate boards.

In that regard, they make a point similar to Reich's. Once financial markets were liberalized, access to capital opened up, and regulations weakened, the entire competitive process changed. But for Rajan and Zingales, "supercapitalism" is a golden age in which investment and financial institutions create a vibrant and creative world of technological progress and efficiency. Inequality, environmental concerns, and the erosion of the "power of the citizen"—Reich's main concerns—do not play much of a role here. Instead, growing competition from foreigners and start-ups bred efficiency, innovation, and eventually a substantial growth in economic well-being. It was a golden age of Schumpeterian creative destruction.

The growth spurt of the U.S. economy, and the increases in productivity and trade that brought it about, are attributed by Rajan and Zingales to capital market liberalization. The data on U.S. growth are a bit iffy here, however. The liberalization of capital markets in the 1970s did not lead to a spurt in growth until the mid-1990s, and arguably one that was temporary: real GDP per capita in the United States grew at a rate of 2.47 percent per year between 1960 and 1975, a growth rate that fell slightly to 2.39 percent in the years between 1975 and 1990 and to 2.03 percent in the 1990s, and then fell further to 1.39 per year after 2000, when financial market liberalization had reached its peak under Republican administrations and majorities in Congress and a pro-deregulation fed chair.[4] This is, of course, not holding other things equal, and it may well be that in the absence of financial deregulation growth rates would have fallen even more.

Rajan and Zingales wrote their book early in the new millennium, and to a reader grown cynical by a continued news diet of mismanaged banks, leveraged hedge funds, securitized subprime mortgages, real estate bubbles, credit default swaps, golden parachutes, shrinking 401(k) values, and Bernard Madoff, much of this book's enthusiasm about unfettered financial markets may sound hollow and ironic. While their book is anything but blind to the potential excesses of financial capitalism, they never imagined how bad things could get around 2008. It is easy to slip into the finger-pointing that says that the entire financial sector was one big Ponzi scheme, and that the growth of the financial sector in recent years constituted "$400 billion a year in waste, fraud, and abuse."[5] But it is precisely here that Rajan and Zingales make an important point: money lenders and financiers may never have been popular, but they play an indispensable role in an efficient

4. All computations from "How Much Is That?" at http://eh.net/hmit/ (accessed 30 December 2008).

5. Paul Krugman, "The Madoff Economy," *New York Times*, 19 December 2008.

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and innovative economy. As they point out, even perfectly legitimate investments sometimes are hard to distinguish from Ponzi schemes, and the losers in the process tend to attribute to fraud and greed what rightfully should be seen as the outcome of uncertainty or at worst incompetence (pp. 234–35). Such recriminations, they warn, are understandable, but they could be dangerous.

How free should financial markets be? To get financial markets to work they cannot be left entirely to their own devices, since they have an innate tendency to become unstable, to fail, and then to drag much of the "real" economy with them. Rajan and Zingales understand this all too well, and neither are they blind to the many opportunities for deception, misrepresentation, obfuscation, and incompetence that free and open financial markets present. As they note, prophetically, it is especially during economic downturns that such abuses come to light and are most acutely felt. They worry that these may lead to overshooting of corrective measures and to the reimposition of serious, possibly fatal, curbs and regulations on financial markets that take us back to the bad old days of limited entry and rent-seeking. For them, bank bailouts signal a danger of returning to an economy in which capital markets are confined to incumbents, in which new firms and fresh ideas are blocked. *Capitalism* as a system in which incumbents are constantly being challenged by competitors is threatened by *capitalists*—the incumbents who will take advantage of the revulsion felt by many of the losers in a financial crisis and return us to the low-pressure, democratic, crony capitalism that Reich is nostalgic for. It seems safe to predict in early 2009 that the pendulum will swing inevitably back to more regulation in the coming years, given how much taxpayer involvement was necessary to save the "free" capital market from self-destruction, but Rajan and Zingales are right in worrying that by going too far, the authorities will toss the financial baby out with the fraudulent bathwater.

William J. Baumol, one of the authors of *Good Capitalism, Bad Capitalism*, is among the most distinguished economists of our age and has been enriching economics with useful and original ideas since the 1950s. In a series of books, he has made a point whose importance cannot be overstated.[6] Society generates individuals who have the drive, diligence, energy, and intelligence to play an active role in bringing about change. These entrepreneurs, however, will try to make money where and how they can. If the institutions of society are such that the incentives point toward making money by technological innovation or other improvements in efficiency, that is where their efforts will go. But if institutions create opportunities to earn money by redistributing wealth from one to another through political

6. William J. Baumol, *Entrepreneurship, Management, and the Structure of Payoffs* (Cambridge, Mass., 1993), and *The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism* (Princeton, N.J., 2002).

or administrative means, entrepreneurs will take advantage of these. The former kind of entrepreneurship produces innovators and engineers who increase wealth, while the latter produces lawyers and lobbyists who redistribute and diminish it. International openness, free entry, and strong rewards for successful innovators make "good capitalism" more likely. For Baumol and his coauthors, there is an innate tendency of "wealth-enhancing" institutions to become stronger as societies become richer (p. 115). Much like Rajan and Zingales, they argue that as financial markets are liberalized and access to capital markets is more widespread, start-ups and venture capital will support innovation and growth. They, too, are aware of the dangers that threaten "good capitalism" and that could transform the American economy into one that is "characterized by ossification, limited incentives, and a paucity of breakthrough inventions" (p. 228). But they are less worried about finance than about the size, political power, and deeper structure of the large corporation.

If the United States returns to a regime of big-firm dominance in which a number of secure but complacent giants enjoy the ultimate economic rent, a quiet life, "bad capitalism" could prevail. Dominant big firms will form powerful lobbies, advancing their special interests and maximizing exclusionary rents instead of the returns to innovation. Of course, as Baumol and his coauthors well realize, much lobbying is already going on, but as long as the regulatory powers of the state are not very wide, the damage that will be caused by the "capture" of the regulatory process by powerful firms will remain limited.

The issues here are complex, and the book is chock-full of wise suggestions on how to reform the patent system, bankruptcy laws, and antitrust policies to protect "good capitalism." Baumol, Litan, and Schram, much like Reich, worry about the power of bad entrepreneurs to defend their special interests and turn their energies and ingenuity into redistribution. But unlike Reich and much like Rajan and Zingales, they think that the tighter competition of the past two decades has been a force that has been all for the good, and they express a concern for a return to the cozy capitalism of the 1950s and 1960s. Yet they worry, as they should, about the growing influence of corporate money in American politics, through campaign donations, revolving-door employment, and the frog legs and sweetbreads Zingara offered in fine Washington restaurants, on which K Street lobbyists presumably feast legislators (Reich, p. 132).

Corporate lavishness may not be anything as deep as "supercapitalism," but just plain rents being sloshed about. But these lobbies, one suspects, are a prime example of "bad entrepreneurship"—talented, highly educated, hard-working men and women who spend their careers seeking tax breaks and legislative favors instead of raising efficiency. One might add that innovation itself is often threatened by a variety of lobbies and rent-seeking interests, from concerned scientists and citizens' lobbies opposed to specific

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new techniques, such as genetically modified organisms and stem-cell research, to product-liability lawyers. Such lobbies are a major threat to and check on technological progress, and clearly the political economy of innovation needs to play a larger role in the analysis of modern capitalism.[7]

Each of the three books I have discussed emphasizes the importance of incentives and competition, and there is no doubt that these are the two pillars on which the culture of capitalism has always stood. But as people have come to realize in recent years, there seems to be a strange asymmetry associated with supercapitalism: while there are mind-boggling opportunities for gains accruing to people who engage in daring and successful projects with other people's money, there seem to be little risks to them. The risks are borne by those who were not asked for their opinions in the first place: employees, shareholders, and taxpayers. Executives and account managers are paid bonuses and can make astronomical amounts on stock options if the stock of the company rises, but they are not penalized in a symmetrical way for driving a company into bankruptcy or losing a client's funds. Bonuses are not matched by fines, and stock options need not be exercised. The downward risk taken by the CEOcracy is thus rather minimal. At worst they get fired—typically cushioned by that most egregious of supercapitalism's innovations, the golden parachute. As a result, the incentives for risk-taking are distorted, with possibly disastrous results.

Things are worse at the macro-level. Financial institutions, with the notable exception of Lehman Bros., are "bailed out" by the government with the argument that letting them fail, despite patent mismanagement, is worse. Governments since 1945 are responsible for keeping the macroeconomy afloat and are providing a safety net for those most affected by economic misfortune. Their incentives are to "save jobs," even at the cost of efficiency. They are also subject to pressures by special interest groups that represent local constituencies, such as the state of Michigan. As a result, governments engage in creative salvation; some large firms cannot be allowed to fail because the local repercussions would be too severe. Arguably, this is another adaptation of twenty-first-century capitalism to the changing times. But it does distort incentives even more.

In the end, then, Reich's concerns about the fragility of capitalist institutions are rightly shared by the other two books. If political markets cannot generate institutions that make supercapitalism acceptable to the majority of agents, capitalism may be in serious trouble. In recent years economists have rediscovered the importance of institutions as the main facilitators of markets, but also of mechanisms to encourage growth and to

7. See Joel Mokyr, "The Political Economy of Technological Change: Resistance and Innovation in Economic History," in *Technological Revolutions in Europe*, ed. Maxine Berg and Kristin Bruland (Cheltenham, UK, 1998), 39–64.

divide up its products.[8] But economic institutions and laws are set by politics and history, and they are not designed to maximize economic efficiency, much less fairness and equity. Indeed, it could be argued that the institutions that created modern capitalism in the West were the results of historical contingencies in certain parts of eighteenth-century Europe not replicated anywhere else. Indeed, the limited-liability corporation, that symbol of Western capitalism, was not readily transplanted to other societies.[9] It might be concluded, therefore, that there is nothing inevitable about its long-term survival. But reports of its demise have proven premature before.

While far from perfect, modern capitalism can be and will be tamed and constrained by politics. This process of taming is itself imperfect, and so what it produces is at most a second-best world. But while Western capitalism is neither fair nor stable, it has one capability that other economic regimes seem to lack: it has an ability to self-correct and adapt when things go wrong. In the past it has repeatedly reinvented itself when it had to, and what came out was an improved model. All three books here seem to be quite clear that they want the system to be saved and make quite detailed proposals on how this should be done. What we have today is "Capitalism 3.1," which seems serviceable for awhile but will surely by replaced by Capitalism 4.0, which will work until the next crisis, when it will have to be updated again. As long as it can do that, the system will survive, and our prosperity and technological creativity with it.

8. Daron Acemoglu, Simon Johnson, and James Robinson, "Institutions as a Fundamental Cause of Economic Growth," in *Handbook of Economic Growth*, ed. Philippe Aghion and Steven Durlauf (Amsterdam, 2005), 385–465; Dani Rodrik, Arvind Subramanian, and Francesco Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," *Journal of Economic Growth* 9, no. 2 (June 2004): 131–65.

9. Ron Harris, "The Institutional Dynamics of Early Modern Eurasian Trade: The Corporation and the Commenda," *Journal of Economic Behavior and Organization*, forthcoming 2009.