

# Dynamic Capitalism

## Entrepreneurship is lucrative--and just.

by EDMUND S. PHELPS  
Tuesday, October 10, 2006 12:01 a.m. EDT

There are two economic systems in the West. Several nations--including the U.S., Canada and the U.K.--have a private-ownership system marked by great openness to the implementation of new commercial ideas coming from entrepreneurs, and by a pluralism of views among the financiers who select the ideas to nurture by providing the capital and incentives necessary for their development. Although much innovation comes from established companies, as in pharmaceuticals, much comes from start-ups, particularly the most novel innovations. This is free enterprise, a k a capitalism.

The other system--in Western Continental Europe--though also based on private ownership, has been modified by the introduction of institutions aimed at protecting the interests of "stakeholders" and "social partners." The system's institutions include big employer confederations, big unions and monopolistic banks. Since World War II, a great deal of liberalization has taken place. But new corporatist institutions have sprung up: Co-determination (*cogestion*, or *Mitbestimmung*) has brought "worker councils" (*Betriebsrat*); and in Germany, a union representative sits on the investment committee of corporations. The system operates to discourage changes such as relocations and the entry of new firms, and its performance depends on established companies in cooperation with local and national banks. What it lacks in flexibility it tries to compensate for with technological sophistication. So different is this system that it has its own name: the "social market economy" in Germany, "social democracy" in France and "concertazione" in Italy.

### Dynamism and Fertility

The American and Continental systems are not operationally equivalent, contrary to some neoclassical views. Let me use the word "dynamism" to mean the fertility of the economy in coming up with innovative ideas believed to be technologically feasible and profitable--in short, the economy's talent at commercially successful innovating. In this terminology, the free enterprise system is structured in such a way that it facilitates and stimulates dynamism while the Continental system impedes and discourages it.

Wasn't the Continental system *designed* to stifle dynamism? When building the massive structures of corporatism in interwar Italy, theoreticians explained that their new system would be more dynamic than capitalism--maybe not more fertile in little ideas, such as might come to petit-bourgeois entrepreneurs, but certainly in big ideas. Not having to fear fluid market conditions, an entrenched company could afford to develop radical innovation. And with industrial confederations and state mediation available, such companies could arrange to avoid costly duplication of their investments. The state and

its instruments, the big banks, could intervene to settle conflicts about the economy's direction. Thus the corporatist economy was expected to usher in a new *futurismo* that was famously symbolized by Severini's paintings of fast trains. (What was important was that the train was rushing forward, not that it ran on time.)

Friedrich Hayek, in the late 1930s and early '40s, began the modern theory of how a *capitalist* system, if pure enough, would possess the greatest dynamism--not socialism and not corporatism. First, virtually everyone right down to the humblest employees has "know-how," some of what Michael Polanyi called "personal knowledge" and some merely private knowledge, and out of that an idea may come that few others would have. In its openness to the ideas of all or most participants, the capitalist economy tends to generate a plethora of new ideas.

Second, the pluralism of experience that the financiers bring to bear in their decisions gives a wide range of entrepreneurial ideas a chance of insightful evaluation. And, importantly, the financier and the entrepreneur do not need the approval of the state or of social partners. Nor are they accountable later on to such social bodies if the project goes badly, not even to the financier's investors. So projects can be undertaken that would be too opaque and uncertain for the state or social partners to endorse. Lastly, the pluralism of knowledge and experience that managers and consumers bring to bear in deciding which innovations to try, and which to adopt, is crucial in giving a good chance to the most promising innovations launched. Where the Continental system convenes experts to set a product standard before any version is launched, capitalism gives market access to all versions.



The issues swirling around capitalism today concern the *consequences* of its dynamism. The main benefit of an innovative economy is commonly said to be a higher level of productivity--and thus higher hourly wages and a higher quality of life. There is a huge element of truth in this belief, no matter how many tens of qualifications might be in order. Much of the huge rise of productivity since the 1920s can be traced to new commercial products and business methods developed and launched in the U.S. and kindred economies. (These include household appliances, sound movies, frozen food, pasteurized orange juice, television, semiconductor chips, the Internet browser, the redesign of cinemas and recent retailing methods.) There were often engineering tasks along the way, yet business entrepreneurs were the drivers.

There is one conceivable qualification that ought to be addressed. Is productivity not finally at the point, after 150 years of growth, that having yet another year's growth would be of negligible value? D.H. Lawrence spoke of America's "everlasting slog." Whatever the answer, it is important to note that advances in productivity, in generally pulling up wage rates, make it affordable for low-wage people to avoid work that is tedious or grueling or dangerous in favor of work that is more interesting and formative.

Of course, productivity levels in the smaller countries will always owe more to innovations developed abroad than to those they develop themselves. Some might suspect that the domestic market is so tiny in a country such as Iceland, for instance, that even in per capita terms only a very small number of homemade innovations would bring a satisfactory productivity gain--and thus an adequate rate of return. In fact, most of the Continental economies, including the large ones, have been content to sail in the slipstream of a handful of economies that do the preponderance of the world's innovating. The late Harvard economist Zvi Griliches commented approvingly that in such a policy, the Europeans "are so smart."

I take a different view. For one thing, it is good business to be an innovative force in the "global economy." Globalization has diminished the importance of scale as well as distance. Tiny Denmark sets its sights on markets in the U.S., the EU and elsewhere. Iceland has entered into European banking and biogenetics. France has long done this--and can do more of it. But it could do so more successfully if it did not insulate its innovational decisions so much from evaluations by financial markets--including the stock market--as Airbus does. The U.S. is already demonstrably in the global innovation business. To date, there is an adequate rate of return to be expected from "investing" in the conception, development and marketing of innovations for the global economy--a return on a par with the return from investing in plant and equipment, software and other business capital. That is a better option for Americans than suffering diminished returns from investing solely in the classical avenue of fixed capital.



I would, however, stress a benefit of dynamism that I believe to be far more important. Instituting a high level of dynamism, so that the economy is fired by the new ideas of entrepreneurs, serves to transform the workplace--in the firms developing an innovation and also in the firms dealing with the innovations. The challenges that arise in developing a new idea and in gaining its acceptance in the marketplace provide the workforce with high levels of mental stimulation, problem-solving, employee-engagement and, thus, personal growth. Note that an individual working alone cannot easily create the continual arrival of new challenges. It "takes a village," preferably the whole society.

The concept that people need problem-solving and intellectual development originates in Europe: There is the classical Aristotle, who writes of the "development of talents"; later the Renaissance figure Cellini, who jubilates in achievement; and Cervantes, who evokes vitality and challenge. In the 20th century, Alfred Marshall observed that the job is in the worker's thoughts for most of the day. And Gunnar Myrdal wrote in 1933 that the time will soon come when more satisfaction derives from the job than from consuming. The American application of this Aristotelian perspective is the thesis that most, if not all, of such self-realization in modern societies can come only from a career. Today we cannot go tilting at windmills, but we can take on the challenges of a career. If a challenging career is not the main hope for self-realization, what else could be? Even to be a good mother, it helps to have the experience of work outside the home.



I must mention a "derived" benefit from dynamism that flows from its effects on productivity and self-realization. A more innovative economy tends to devote more resources to investing of all kinds--in new employees and customers as well as new office and factory space. And although this may come about through a shift of resources from the consumer-goods sector, it also comes through the recruitment of new participants to the labor force. Also, the resulting increase of employee-engagement serves to lower quit rates and, hence, to make possible a reduction of the "natural" unemployment rate. Thus, high dynamism tends to bring a pervasive prosperity to the economy on top of the productivity advances and all the self-realization going on. True, that may not be pronounced every month or year. Just as the creative artist does not create all the time, but rather in episodes and breaks, so the dynamic economy has heightened high-frequency volatility and may go through wide swings. Perhaps this volatility is not only normal but also productive from the point of view of creativity and, ultimately, achievement.

### **Ideals and Reality**

I know I have drawn an idealized portrait of capitalism: The reality in the U.S. and elsewhere is much less impressive. But we can, nevertheless, ask whether there is any evidence in favor of these claims on behalf of dynamism. Do we find evidence of greater benefits of dynamism in the relatively capitalist economies than in the Continental economies as currently structured? In the Continent's Big Three, hourly labor productivity is lower than in the U.S. Labor-force participation is also generally lower. And here is new evidence: The World Values Survey indicates that the Continent's workers find less job satisfaction and derive less pride from the work they do in their job.

Dynamism does have its downside. The same capitalist dynamism that adds to the desirability of jobs also adds to their precariousness. The strong possibility of a general slump can cause anxiety. But we need some perspective. Even a market socialist economy might be unpredictable: In truth, the Continental economies are also susceptible to wide swings. In fact, it is the corporatist economies that have suffered the widest swings in recent decades. In the U.S. and the U.K., unemployment rates have been remarkably steady for 20 years. It may be that when the Continental economies are down, the paucity of their dynamism makes it harder for them to find something new on which to base a comeback.

The U.S. economy might be said to suffer from incomplete inclusion of the disadvantaged. But that is less a fault of capitalism than of electoral politics. The U.S. economy is not unambiguously worse than the Continental ones in this regard: Low-wage workers at least have access to jobs, which is of huge value to them in their efforts to be role models in their family and community. In any case, we can fix the problem.

Why, then, if the "downside" is so exaggerated, is capitalism so reviled in Western Continental Europe? It may be that elements of capitalism are seen by some in Europe as morally wrong in the same way that birth control or nuclear power or sweatshops are

seen by some as simply wrong in spite of the consequences of barring them. And it appears that the recent street protesters associate business with *established* wealth; in their minds, giving greater latitude to businesses would increase the privileges of old wealth. By an "entrepreneur" they appear to mean a rich owner of a bank or factory, while for Schumpeter and Knight it meant a newcomer, a *parvenu* who is an outsider. A tremendous confusion is created by associating "capitalism" with entrenched wealth and power. The textbook capitalism of Schumpeter and Hayek means opening up the economy to new industries, opening industries to start-up companies, and opening existing companies to new owners and new managers. It is inseparable from an adequate degree of competition. Monopolies like Microsoft are a deviation from the model.

It would be unhistorical to say that capitalism in my textbook sense of the term does not and cannot exist. Tocqueville marveled at the relatively pure capitalism he found in America. The greater involvement of Americans in governing themselves, their broader education and their wider equality of opportunity, all encourage the emergence of the "man of action" with the "skill" to "grasp the chance of the moment."



I want to conclude by arguing that generating more dynamism through the injection of more capitalism does serve economic justice.

We all feel good to see people freed to pursue their dreams. Yet Hayek and Ayn Rand went too far in taking such freedom to be an absolute, the consequences be damned. In judging whether a nation's economic system is acceptable, its consequences for the prospects of the realization of people's dreams matter, too. Since the economy is a system in which people interact, the endeavors of some may damage the prospects of others. So a persuasive justification of well-functioning capitalism must be grounded on its all its consequences, not just those called freedoms.

To argue that the consequences of capitalism are just requires some conception of economic justice. I broadly subscribe to the conception of economic justice in the work by John Rawls. In any organization of the economy, the participants will score unequally in how far they manage to go in their personal growth. An organization that leaves the bottom score lower than it would be under another feasible organization is unjust. So a new organization that raised the scores of some, though at the expense of reducing scores at the bottom, would not be justified. Yet a high score is just if it does not hurt others. "Envy is the vice of mankind," said Kant, whom Rawls greatly admired.

### **The 'Least Advantaged'**

What would be the consequence, from this Rawlsian point of view, of releasing entrepreneurs onto the economy? In the classic case to which Rawls devoted his attention, the lowest score is always that of workers with the lowest wage, whom he called the "least advantaged": Their self-realization lies mostly in marrying, raising children and participating in the community, and it will be greater the higher their wage.

So if the increased dynamism created by liberating private entrepreneurs and financiers tends to raise productivity, as I argue--and if that in turn pulls up those bottom wages, or at any rate does not lower them--it is not unjust. Does anyone doubt that the past two centuries of commercial innovations have pulled up wage rates at the low end and everywhere else in the distribution?

Yet the tone here is wrong. As Kant also said, persons are not to be made instruments for the gain of others. Suppose the wage of the lowest-paid workers *was* foreseen to be reduced over the entire future by innovations conceived by entrepreneurs. Are those whose dream is to find personal development through a career as an entrepreneur not to be permitted to pursue their dream? To respond, we have to go outside Rawls's classical model, in which work is all about money. In an economy in which entrepreneurs are forbidden to pursue their self-realization, *they* have the bottom scores in self-realization--no matter if they take paying jobs instead--and that counts whether or not they were born the "least advantaged." So even if their activities did come at the expense of the lowest-paid workers, Rawlsian justice in this extended sense requires that entrepreneurs be accorded enough opportunity to raise their self-realization score up to the level of the lowest-paid workers--and higher, of course, if workers are not damaged by support for entrepreneurship. In this case, too, then, the introduction of entrepreneurial dynamism serves to raise Rawls's bottom scores.

Actual capitalism departs from well-functioning capitalism--monopolies too big to break up, undetected cartels, regulatory failures and political corruption. Capitalism in its innovations plants the seeds of its own encrustation with entrenched power. These departures weigh heavily on the rewards earned, particularly the wages of the least advantaged, and give a bad name to capitalism. But I must insist: It would be a non sequitur to give up on private entrepreneurs and financiers as the wellspring of dynamism merely because the fruits of their dynamism would likely be less than they could be in a less imperfect system. I conclude that capitalism is justified--normally by the expectable benefits to the lowest-paid workers but, failing that, by the injustice of depriving entrepreneurial types (as well as other creative people) of opportunities for their self-expression.

*Mr. Phelps, the McVickar Professor of Political Economy at Columbia, was yesterday awarded the 2006 Nobel Prize for economics. Click [here](#) to read a selection of his previous articles from The Wall Street Journal.*