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# The Justice of a Well-Functioning Capitalism and the Reforms that Will Realize It, Not Kill It

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It is a privilege to expound my views at this brilliant symposium on what President Sarkozy terms a *refounding* of capitalism.

My position is that countries cannot afford to jettison the innovative activity of entrepreneurs, investors, pioneering managers and their employees that – for two centuries now – has been drawing an ever widening share of people in an ever-growing number of nations into engaging jobs, exciting explorations and remarkable commercial advances. I will try to explain, getting finally to issues of instability.

*What is capitalism?* Any concept of a capitalist economy must include *private wealth owning*. Yet that private wealth must extend to ownership of all or most of the economy's *business capital* – not merely cars, homes and debts of the state and state enterprises, as under market socialism. It is also necessary that private owners of businesses be accorded *control* over where to *invest* – not just along the narrow lines assented to by managers, guilds or unions, as in corporatism, or in ways dictated by the state or oligarchs. There survives an image of capitalism as a game in which each generation's players make their moves in hopes of riches, then, leave the field to take stock of the wealth they won or lost. But these wealth-centered features are insufficient to capture the character of capitalism in the modern age.

The spirit of capitalism took form in the 19th century. With the development of company law, corporate finance, investment banking and patent law, the way was opened for a process of innovation: the conception of novel commercial ideas; the selection by financiers of some of these ideas for development, the realization by entrepreneurs of the envisioned products or methods, and the adoption or rejection by managers or consumers of some of the new products reaching the market. In this process, private ownership is typical at every stage, required or not. *Laisser-faire* – a *free market* of low taxes, tariffs and regulation – is *not* required; it may undermine capitalism's functioning.

Note that a new commercial idea in a country may be an application of an invention or discovery made by scientists *outside* the economy or an innovation made by a business in *another* economy. That was Josef Schumpeter's early view of how commercial ideas came to a country.[1] (He wrote that developing a new idea into a new product at an economical price required the skills of a savvy entrepreneur.) Instead, the new idea might come from *inside* the nation's economy: an original idea inspired by the observations and imagination of producers, employees, managers or consumers – people "on the spot." This was the view of Friedrich Hayek.[2] It is the view of most experts today.[3] If innovation were mere Schumpeterian application or imitation, a socialist system could approximate the results of a capitalist system.[4]

*What is the distinctive merit of capitalism?* For many, capitalism's main merits are the wealth accumulation it fosters and the "individual freedom" it helps to protect. Referring to capitalism in his Inaugural Address, President Obama said, "Its power to generate wealth and expand freedom is unmatched.[5] For me, that does not capture the value of a well-functioning capitalism.

As for wealth, it may be that the challenge of attaining greatly increased wealth in one's young or middle years is absorbing and fun: as Nietzsche and Frank Knight might have remarked, it is like participating in a sport. Yet social observers are right to question whether people find significant satisfaction *beyond some point* from increased *relative* wealth.[6] After you have *won the game*, what point is there in winning by a bigger *point spread*? Many entrepreneurs speak of the wealth received as a by-product of what they sought to do or achieve rather than as the goal. In any case, an increase in some people's relative wealth means a *decrease* in some others' relative wealth. The value of *nationwide* advances in wealth might seem to be on more solid ground. It *is* better to have more wealth in a city or nation where most other have more wealth too: possibilities of a richer and more rewarding life result.

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[1] Schumpeter, *Theorie der wirtschaftlichen Entwicklung*, Leipzig: Duncker & Humblot, 1912.

[2] The earliest example is F. A. Hayek, *Collectivist Economic Planning*, London: Routledge, 1935. See also Hayek, "Competition as a Discovery Procedure [1968]," in Hayek, *New Studies in Philosophy, politics, Economics, and the History of Ideas*, Chicago: Univ. of Chicago Press 1978.

[3] It is the view of Alfred Chandler, Peter Drucker, Richard Nelson, Sidney Winter, Giovanni Dosi, Roman Frydman and Andrzej Rapaczynski, Virginia Postrel, Amar Bhide and my view too.

[4] In the U.S. the greater part of medical progress comes from practice, not from science. See Richard Nelson, XXXX, 2008.

[5] Barack Obama, Inaugural Address, February 20, 2009.

[6] I am thinking of attitude surveys and commentaries by Bruno Frey, Richard Layard and Andrew Oswald,, to name just those that immediately come to mind.

The fault in this view is that the relatively capitalist countries are *not* distinguished by high wealth levels. The somewhat more socialist economies and more corporatist economies of western Europe reach wealth levels *exceed-ing* the levels in the capitalist economies. The reasons are familiar. One of the major drivers of wealth, the propensity to save, is higher in Luxembourg, Switzerland, Belgium, France and Germany than in the U.S., the U.K. and Canada – despite the high security offered by the continental welfare system.

The other driver of private wealth, namely, the level of productivity, is also equal if not greater in the former group of countries than in the latter group. A proposed explanation is that while those capitalist exemplars may be at or close to the "technical frontier," thanks to their "lead" in cutting-edge innovation, they "waste" much of their output potential in false steps, in the costly processes of marketing, and an over-investment caused by the winner-take-all competition of costly R&D projects.[7] Furthermore, the top-down techno-nationalist projects that some relatively corporatist nations have substituted for discoveries bubbling up naturally from the business sector may do well on that score thanks to the resources saved by avoiding "wasteful competition" for new products involving parallel development work and marketing efforts. One has to conclude that "*generation of wealth" is not special to capitalism*. Corporatist economies are as good at that.

As for freedom, it has been argued that a capitalist economy far more than a socialist or a corporatist economy offers helps to buttress people's *personal* and *political* freedoms against the tyrannies of the state, communities and the culture. Owners of a firm in a capitalist economy would feel it in their pocket book if employees were hired or fired on the basis of their beliefs rather than the firm's profits.[8] Yet the evidence is mixed: Some of the relatively socialist and corporatist economies of western Europe appear to be extraordinarily tolerant of deviance from the mainstream.

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[7] Historically, some corporatist economies have sought to substitute a top-down "scientism" for the discoveries bubbling up naturally from the business sector. Of course, the techno-nationalist projects undertaken in corporatist economies may produce some productivity gains. Yet the selection among these projects and the development decisions along the way are not immune to mis-steps. And techno-nationalism is prone to flaws of its own, such as a tendency to the grandiose and to over-engineering. So it is doubtful that industrial research policy can be credited for the good productivity levels exhibited in some corporatist economies.

[8] See for example Henry C. Wallich, *The Cost of Freedom*, New York, Harper, 1960. Somewhere Wallich wrote that "power is the great enemy of freedom."

A merit of a well-functioning capitalism – I do not free-market policies: low tax rates, etc. – is the *economic* freedoms it provides entrepreneurs, managers, employees and consumers that socialist or corporatist systems do not provide.[9] In Friedman's work, the "freedom to choose" derives its value as a means to *income*.[10] He suggests that incomes will be higher when participants are free to move over a wide range of regions, occupations and industries and when individuals and enterprises are free to collect micro data on which to make decisions. But that is a thesis that well-functioning capitalist economies, owing to their freedoms, are better at producing income and wealth than more corporatist systems (and socialist ones). As noted earlier, the best corporatist economies tend to exhibit comparable productivity.

The work of Hayek from his *Road to Serfdom* onward suggests another kind of value in economic freedoms[11] In any real life economy (not theoretical models in which everything in the present and the future is known), actors may sense or conjecture opportunities or dangers about which there is little or no public knowledge while the individual has significant *private knowledge* about possible benefits or costs as well as *imagination* and *personal experience*. Individuals' freedoms *to act* (or not act) on their unique knowledge, intuition and judgment may be indispensable to people's sense of self-worth and self-reliance. In this view, it would be *inadequate* to gauge the value of freedom by its contribution to income, consumption, investment and even to the pragmatists' "expansion of talents" and "capabilities." The freedom to act on this basis – to take charge of one's own heading and make one's own mistakes – is a primary good in itself, one of huge importance. Is there evidence of greater economic freedoms in capitalist economies than in the more socialist or corporatist economies?[12] My research using survey data supports the widespread impression that, in the relatively capitalist economies, people in

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[9] Some of the public discussion here looks convoluted. It makes no sense to say that a merit of such a system is that it provides freedoms without which the system could not function. It is necessary to explain what the value to people of such freedoms might be.

[10] Milton Friedman, *Capitalism and Freedom,* Chicago: University of Chicago, 1962, and Milton & Rose Friedman, *Free to Choose*, New York, Harcourt, 1980.

[11] Hayek, *The Road to Serfdom*, London: Routledge, 1944. See also the commentary in Amartya Sen, "An Insight into the Purpose of Prosperity," *Financial Times*, September 20, 2004.

[12] Jeffrey D. Sachs says no in his "Response to Easterly on Hayek," *Greg Mankiw's Blog*, Monday, November 27, 2006. He notes that the Heritage Foundation/Wall Street Journal Index of Economic Freedom ranks Finland, Sweden and Denmark as 'free economies,' with Denmark ranked ahead of the United States – and this in spite of their high rates of taxation, which counts heavily in the Heritage index. This is undeniably interesting, since those three countries are widely regarded as pretty corporatist as well as somewhat socialist. However, the Heritage indicators of "freedom" largely differ from the individual freedoms in the workplace, financial markets, and product markets that I am clearly referring to.

ordinary jobs have freedoms that they value – more than workers in the relatively socialist or corporatist economies. In the former economies more than in the latter, workers say they want jobs offering chances to take initiative and responsibility, which reveals that they know such jobs are available, while acknowledging also the value of teamwork – thus the need both to give orders and take orders.[13]

It is important also to make explicit what Hayek must have believed but did not say. As a long line of Western humanists and philosophers propounded from Bergson, James and Hume on back to Cervantes, Cellini and Virgil, in a significantly unknown world, an individual's freedoms to experiment, to learn, to explore, to act on impulse, and to test ideas offer personal benefits in another category under the heading of *personal growth*: expansion of "talents" and "capabilities," widening experience and self-discovery. In my work I suppose that all or most people are capable of finding such satisfactions from taking part in the innovation process of a capitalist economy: examining untried ways of producing something, conceiving and developing an innovative product or method, and pioneering the adoption of a new product or method. [14]

In this view, the dynamism of a well-functioning capitalism has a fundamental merit. Ordinary people, if they are to find intellectual growth and an engaging life, have to look outside the home: they can only be found at work, if anywhere. And for these rewards to be available for large numbers of people, the economy has to be based predominantly on a well-functioning capitalist system. Thanks to the grassroots, bottom-up processes of innovation, it can deliver – far more broadly than Soviet communism, eastern European socialism, and western European corporatism can – chances for the mental stimulation, problem-solving, exploration and discovery required for a life of engagement and personal growth.[15]

*Can dynamism justify capitalism?* Could it be that a well-functioning capitalism's value in providing opportunities to act on their own knowledge, intuition and judgment and its value in providing opportunities to be engrossed and to flourish serve to *justify* that capitalism? It is clear how that might be argued: *If a well-functioning capitalist system offers broad numbers in society chances for a life of initiative and discovery while the other systems deprive people of that*

[13] Phelps, "Economic Culture and Economic Performance: What Light is Shed on the Continent's Problem," 3rd Annual Conference of the Center on Capitalism and Society, Venice, July 2006.

[14] See my Prize Lecture, "Macroeconomics for a Modern Economy," Stockholm: Nobel Foundation, 2007, and papers of mine going back at least to 2003.

[15] My argument can be sampled in my paper for a 2003 Baumol conference and my June 2006 speech at Sciences-Po as well as the Venice paper and Prize Lecture cited above.

*experience, then imposing the latter systems on society would be terribly unjust.* The answer would appear to be yes.

A plausible objection is that even a well-functioning capitalist system would not be just if it failed to strive for the largest possible *inclusion* of the productive population in that system. It can be accepted that such a system is not fully just, thus unjust. (I certainly agree.) But that does not imply that dynamism cannot be just until a just level of inclusion is sought and achieved. Moreover, it is not capitalism that stands in the way of inclusion; it is the inadequacy of wage subsidies.

*Taking instability and crisis into account.* When President Sarkozy spoke of a "refounding" of capitalism I wondered whether he had in mind what might be termed a capitalist *reformation* that is analogous to the Protestant Reformation in the 1500s. There is the appearance of a parallel between the Church's creation in medieval times of lucrative indulgences, which national governments did nothing to stop, and the banking industry's sale in recent years of overvalued packages of mortgages, called CDOs, which governments did nothing to stop. But the banks held such CDOs on their own account – they did not only sell them to naïve buyers. The moral shortcoming in the banks, it appears, was that the leaders did not have the moral strength to protest the rise of leverage and the deterioration in the quality of the securitized assets to which they gave their seal of approval. With varying discomfort, the CEOs seem to have felt too weak ever to try to call a halt to further expansion of credit – to "get off the merry-go-round," in the famous words of Charles ("Chuck") Prince, former CEO of Citigroup.

I feel that in combating this part of the problem in the financial sector the first line of defense ought to be laws and regulations. Altruism is a valuable resource but we do not want to risk causing havoc with it by appealing to it in a comprehensive way at all levels of life. There must be social responsibility at some critical points but we cannot afford to over-use this resource lest we find ourselves with too little of it left when we need it most.

How does the element of *instability* in capitalist systems affect the argument for continuing with capitalism? One's first reaction, especially if one has high appreciation for capitalism, might be to say that the big swings to which capitalist systems are inherently prone, should not stay society's hand in creating and maintaining a system that is so essential to engaging work and personal growth. The instability experienced does diminish our satisfaction as participants in the economy but it does not diminish our thirst for the good life.

On reflection, there are valid points in favor of regulation aimed at reducing vulnerability to severe fluctuation. First of all, the good life is not a binary variable: you have it or you don't. A capitalism system dogged by frequent crisis and fears of crisis may levy a toll not only on people's comforts and sense of security but also on the generation of innovation itself. So there may be a *gain* in the *degree* of dynamism to be obtained by fortifying the financial system from speculative crises. The second point I would make involves another dimension: No human system can be expected to be innovative all the time, just as no composer would be expected to be in the heat of creation all the time. It is possible, then, that a financial system that is more robust in the face of speculative movements will exhibit dynamism a greater *proportion* of the time – thus, innovation smoothing. So, in principle, creating a financial sector that is less vulnerable to speculative shifts might not be harmful to dynamism.

Indeed, most economists discussing needs for financial reform appear to believe that better alignment "incentives" and serious regulatory restraints on ruinous competition for profits, though aimed at "economic efficiency" and maybe increased returns to shareowners, will cost the economy nothing in innovation and employment. But this sort of theorizing, though well-intentioned and even useful in exposing the perils of excessive gearing of pay to crude measures of performance, is itself dangerous in leaving the impression that, after reforming bonuses, asset markets will no longer be susceptible to huge asset price swings that are driven only by "speculative excesses" (to use Spiethoff's convenient shorthand).

*Unambiguously good reforms* Do there exist reforms that address speculative swings while causing little or no damage to economic dynamism and inclusion? There are ways of fortifying the financial sector against the speculative fever of investors and entrepreneurs in the business sector without obstructing the speculative investment waves that are emblematic of a healthy capitalism. One suggestion, which comes from my colleague Richard Robb, calls for a small tax on the short-term indebtedeness of financial companies, including the banks. So much of the banks' problems came from excessive short-term borrowing of little or no social utility. Let us tax that in order to force banks to finance their lending with long-term borrowing instead. There are also ways of tempering the speculative swings themselves without suppressing the spirit of capitalism. A suggestion from my long-time collaborator Roman Frydman calls for the introduction of a band around the index of housing prices, a band around the main index of stock market prices and so forth. When the index rises or falls outside the band, the government will increase margin requirements, short-selling requirements, and various other costs so as to dampen – but not outlaw – speculation on a further move of the asset price index.

Do there exist reforms that would address the decline of economic dynamism in the past decade while causing little or no increase in instability? I have been moving toward a proposal to establish *new banks of a new kind*. It is not uncommon to see financial entities in a country that are dedicated to residential construction or to agriculture or to exports and so forth. This is curious and disturbing since little or no economic dynamism comes from our stock of housing as against, say, our stores of clothing and from producing for export rather than home use. (The agricultural sector too has not been celebrated much for its dynamism, however unfair that may be in some cases.) There is no awareness among the general public and its legislatures that most of the economic dynamism inherent in the structure of a country's economy comes from the innovative inclinations of the ordinary people making their careers in the business sector! To right the balance, I suggest to every country that its government establish a corps of banks that are dedicated to lending to – or investing in – companies in the *business* sector. This is not really "new." I like to remind audiences that Germany, with its famous Deutsche Bank, had just such a financial institution serving its business sector over the decades of its brilliant economic development – especially in the 1880s and 1890s, when the bank powered the birth of the electrical engineering industries in Germany. (It also lent to the Edison Company in New Jersey.)

Do there exist reforms that would address the still insufficient levels of economic inclusion without stifling dynamism? Here I would recall the sort of program that has been adopted to a degree in France, the Netherlands and most recently in Singapore: subsidies to companies for their ongoing employment of low-wage workers. Notwithstanding these breakthroughs, it remains true that the United States has as yet no program of general subsidies for low-wage employment. And the outlays of this kind in Europe are still under 2 per cent of the GDP.

Yet there is the looming threat that the public, in its understandable desire to keep fluctuations within tighter limits, will push regulations affecting incentives and competition to a point where a *tradeoff* begins: where further regulatory tightening weakens or narrows some of the sources of dynamism. Europeans, in vilifying all hedge funds, all private equity and all short selling, make it much more difficult than it is already was to increase dynamism in their economies – and without getting at the real sources of excessive instability. It is to be hoped that the Europeans will come to see that they are aiming their wrath at the wrong targets.