The Challenge of Sustaining Capitalism

With this paper, the Committee for Economic Development (CED) launches a multi-year research project on “sustainable capitalism” timed to coincide with CED’s 75th anniversary in 2017. We use the term “sustainable capitalism” because we seek to ensure that the U.S. system of free enterprise remains viable and vibrant for the long term. The systems and institutions of capitalism have proven their value over time by raising incomes and living standards not only for Americans but also for people throughout the world. No other economic system rivals capitalism for its dynamism, innovation, wealth creation, and productivity. It supported and facilitated the creation of the greatest power on earth, allowing for the projection of freedom, democracy, peace, and rising economic standards around the globe.

In our work we will give attention to the complaints, often shrill, about the shortcomings of capitalism. The “Occup Wall Street” movement is one example. Another comes from those who believe that the “Washington Consensus” about the world’s economic system is evolving into a “hybrid” system influenced by the state-controlled industries of China.

To date, business’s reaction to this criticism generally has been characterized as ineffectual. For example, New York Times columnist David Brooks wrote in 2013, “Business leaders have been inept when writers, intellectuals and politicians attacked capitalism.” We hope to remedy this concern in a constructive way. We do not begin from the premise that our market system is in grave danger or that it needs fundamental change. Our objective, rather, is to examine the extant complaints about capitalism, to defend the system from those that are unfair, and to suggest remedies with respect to those that are substantive. In short, we will consider what business can do to strengthen and improve the state of free market capitalism.

CED’s research program on sustainable capitalism will consider and analyze the questions posed below, along with others we may add in the course of further discussion, as we seek solutions for any valid concerns that we may find.

- Could the growth of co-opted relationships between larger businesses and government undermine the competition, innovation, and individual initiative that are at the heart of capitalism? In this regard, we will evaluate the growth of lobbying activity over the past 25 years, and its influence on those competitive forces that are at the core of capitalism.
- To what extent has the growth of larger global companies affected the public view of capitalism?
- Are there corporations that have too great a focus on maximizing short-term benefits for shareholders at the expense of optimizing profits over the long run?
- Are complaints about the failure of corporations to balance the need of their various "constituencies" for the sake of maximizing profits justified?
- Does business bear some responsibility for income equality? Whether it does or not, what, if anything, can business do to alleviate the problem?

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1 We recognize that the word “sustainable” also can be associated with environmental issues. Certainly, care for the environment is an important part of society’s and capitalism’s long-term future. Nevertheless, we are in this report focused on the long-term sustainability of capitalism.
How, if at all, has the growth in size and influence of the financial services industry affected the state of capitalism and the public opinion of capitalism? What is the role of government in directing and overseeing it, or should it be left to free market? If there is a government role, what is the ‘optimized’ regulatory regime in the context of sustainable capitalism, including any government support, subsidies and tax policies?

In a separate paper that we expect will be released in the coming months, we will trace changes that have occurred since World War II in:

- The growth and change in business and corporate governance;
- The growth in size, scope, and power of government;
- The effect that changing technology has had on the labor force; and
- The globalization of the world economy.

Businesses / Government Relationships

Capitalism as we know it in the United States is in a constant state of evolution. Our analysis of capitalism starts at the end of the World War II, just after CED’s founding in 1942. Our focus is on the larger global corporations that are the subject of most expectations as well as criticisms. Those firms have been in the forefront of change and innovation, but also often introduce the largest peril to sustainable capitalism.

One allegation is that dynamic start-up companies, which are responsible for much of the nation’s innovation and job growth, often are at a systematic disadvantage. This view holds that large incumbent businesses are doing far more than defending themselves from government – that they too often engage in “rent seeking” to secure government support, or to influence policies toward trade or protectionism, instead of maintaining a focus on competition and innovation in the marketplace. A widely regarded economist, Luigi Zingales of the University of Chicago, has written that a “lack of competition and the distortions caused by government subsidies are the primary cause of all the problems we face in the economy today, including the declining real incomes of middle class America.” We will examine his concern, consider its accuracy, and determine what if anything business leaders can do about it.

Some have called the business/government relationship “collusive capitalism.” This is not our preferred term because it insinuates that business and government systemically engage in active, overt collusion. We prefer the term “co-opted” capitalism instead.

It does seem apparent that the simultaneous growth of both business and government has greatly increased the impact of governmental rules and decisions on the economy and on businesses of all sizes. Whether made at the request of business or not, governmental decisions can have a major impact on an industry and on individual companies. Thus, it is understandable that businesses will attempt to defend themselves by seeking to shape governmental action for their specific benefit.

We will attempt to evaluate the impact of the business-government relationships on our economy and on public respect for capitalism, and consider what steps can be taken by business and
government to reduce that impact. In conjunction with this work we will examine the degree to which business-government relationships have spurred the growth of this country’s lobbying establishment. It is reasonable to assume that the greater source of revenues for lobbying is the large global companies. We will attempt to determine whether there is reason to believe that, on balance, lobbying of the these larger companies is negatively impacting the smaller and medium-sized companies of the United States.

To what extent has the growth of larger global companies affected the public view of capitalism?

Fifty years ago, there were some U.S.-based firms that had businesses in foreign companies. But today, the United States is the home of gigantic global businesses that often have more employees, more facilities and more profits related to their foreign operations than to their operations here. Their management and their boards have an international outlook and must deal with the laws, policies and public opinions of other countries just as they must deal with those issues in the United States.

These changes are, of course, a natural consequence of globalization; but do they also have unexpected structural consequences? Do large companies have a different sense of citizenship; is their view of the social contract different than it used to be or than the views of smaller companies; and if these differences exist, do they matter?

We will examine these issues to determine what action, if any, should be taken by these global entities or by our government with respect to them.

Are too many corporations focusing on maximizing short-term profits at the expense of greater long-term returns?

Short-termism describes the alleged tendency of some corporate managers to focus on short-term results at the expense of optimizing the larger rewards that can come from a longer-term view. Roger Martin, Dean of the Rotman School of Management at the University of Toronto, speaks of corporate managers who create what he calls an “expectations market,” trumpeting, quarter-by-quarter, what the “market” can expect from their company, reaping gains or losses based on whether they deliver. As a result, trading in stocks, bonds, options and derivatives encourages decisions aimed at short-term market results, making, he says, “the realization of quarterly profits the supreme goal of management.” Are these concerns accurate, and if so, how serious are their consequences? What is the role of compensation and the way managers and executive are compensated and incentivized in these alleged problems?

Do corporations appropriately balance the need of their various “constituencies”?

A separate issue is whether many corporations ignore the interests of their “other constituencies” in efforts to maximize shareholder profits. Those who make such charges claim that these companies are creating social friction by ignoring the greater goals of society. There is no consensus on the identity of these “constituencies” or on how any given corporation should balance corporate profits against the interest of them.
Some assert that corporations selfishly shift work to other countries to increase profits at the expense of the U.S. economy. Others argue that companies too often ignore environmental damage done by investments that increase corporate profits. Some complaints about shareholder primacy are present in calls for corporations to demonstrate more social responsibility.

We will examine these complaints with the objective of determining which of them may be valid and what responsibility, if any, business has with respect to them.

**Economic Inequality**

A slowdown of income growth for individuals and families in the middle and lower ends of the earnings scale since the 1970s has increased public concern about the economic and social effects of widening gaps in the distribution of income and wealth. Young people entering the workforce, particularly low-skilled workers, are particularly affected.

Also, there is evidence that intergenerational economic mobility – the ability to improve economic status from one generation to the next – has diminished, suggesting lessened opportunity for lower-income individuals to improve their economic status. We will examine complaints that business practices are to some degree responsible for such inequality, along with the question of what, if anything, business can do to alleviate these inequalities. Related to this, we will in particular consider allegations that current levels of executive compensation have exacerbated public disenchanted with capitalism.

David Brooks commented in a column earlier this year that “The inequality debate is confusing matters more than clarifying them and it is leading us off in unhelpful directions.” We will attempt to clarify the debate, and will also examine what, if anything, business can do to ameliorate income inequality while still promoting capitalism and innovation. This examination will include the charge of Professor Zingales that government support of some businesses at the expense of others is a major cause of inequality.

Similarly, has the growth in size and influence of the financial services industry affected the state of capitalism and the public opinion of capitalism? Financial sectors grow disproportionally as countries become richer. Rich-nation economies have more, larger, and more complex transactions. The fundamental allocation tasks of any financial sector – between savings and investment; between the present and the future; and across various risk preferences – are at a much larger scale in richer nations. Pension systems are much bigger. The result is that richer countries – including the United States – have financial sectors between two and three times larger as a percent of GDP than middle-income countries. But Professor Simon Johnson argues that the growth of our financial services industry has caught the United States in a “rich-country trap:”large complicated financial sectors and institutions have become inherently destabilizing to the macro-economy. He suggests that a larger and more complicated financial sector focuses increasingly on exotic financial instruments at the expense of the “plain-vanilla” financing which is crucial to small and mid-sized companies.
We will examine this allegation to determine whether a larger financial sector has moved or could move energy and dynamism away from innovation and growth in the real goods and services economy. In short, has “financialization” in our economy increased inequality in America?

Summary

CED’s work over the next five years will celebrate our 75th anniversary with a rededication to our fervent belief in the free-market economic system, our brand of capitalism, which has brought wealth and higher living standards to America and to a very large part of the world. Whatever legitimate complaints there may be about our financial markets and about behavior of some companies or financial institutions, it is undeniable that free-market capitalism as a broad principle of the allocation of scarce resources has brought literally hundreds of millions of people out of abject poverty to middle class status.

Like the business leaders who founded CED, we undertake our project on the challenge to sustainable capitalism with a clean slate. We do not begin our work believing either that our market system is under mortal threat or that it needs substantial change. Our purpose is solely to examine complaints that have been raised about capitalism – to defend the system from those that are unfair, and to suggest remedies that can be taken with respect to those that are substantive.

We will begin our efforts with an examination of business-government relations. We plan to issue a report on these efforts in 2014.