The Challenge of Sustaining Capitalism

With this prologue, 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. This project takes its inspiration from CED’s founding in 1942, when a small circle of original Trustees perceived U.S. capitalism in suspended crisis – suspended by the imperative of mobilization for the war, and at risk of immediate return to the Great Depression once that war imperative ended. In response to the current anxiety about U.S. capitalism after the financial crisis, we have begun this new project with the spirit of our founding, and plan to complete this effort with a volume of our assembled papers as part of the celebration of our forthcoming anniversary.

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.1 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 about the shortcomings of capitalism, coming from both the political left and right – ranging from those who question the motives of today’s business leaders, to those who believe that the “Washington consensus” about the world’s economic system is evolving into a “hybrid” system like the state-controlled industries of China.

Of necessity, we start this potentially enormous discussion from absolute bedrock fundamentals. What is an “economic system?” What gives us pause about the system we have? What conceivable alternatives are there, and if there is none that we would choose, what are the problems with the one we have and how do we address them?

So, to begin, what is an “economic system?” This is not a question – as fundamental as it might be – that very many people feel compelled to address during any given working day. Adam Smith, who identified by many as the 18th century founder of modern economics, neither created nor established the economic system of his time and place – what both many advocates and critics now call “free enterprise” or “capitalism.” Rather, he observed, described, and analyzed what he saw around him, from people acting instinctively rather than in a reasoned way. It was Smith, of course, who recognized the “invisible hand” achieving optimal outcomes because people – with the institutions of personal freedom and protection of private property – did what came naturally in terms of allocating their labor and their savings and investment to their best and most valuable uses. Thus, markets drive efficient use of resources.

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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, in this report we are focused on the long-term sustainability of capitalism itself as our economic system.
Prior to Adam Smith (and with apologies to the earlier “worldly philosophers” whom we often forget or fail to recognize), there were alternative “economic systems.” Those alternatives generally were based on sovereign fiat. The crown might command the allocation of labor, and people would be put in roles that suited the crown’s wishes – even if particular persons were poorly suited for their jobs, or perhaps their jobs should not even have been done in the first place. And the crown might own and allocate investment resources, often into forms that were self-gratifying rather than those that would generate the most economic value. In fact, it was probably some knowledge of the tainted fruits of command economies that caused Adam Smith to recognize as remarkable the achievements of the un-self-conscious free-market or “capitalist” economy that inspired his writing of *The Wealth Of Nations*.

So Adam Smith laid the intellectual groundwork for other thinkers to engage about the economic system in a much more self-conscious way. And some did. Tomes were written to espouse communism and socialism as alternative economic systems. Most U.S. economists today likely would characterize those systems as resource allocation by the sovereign with the additional assurance from the systems’ advocates that the chosen sovereign’s allocation would be fairer or more ethical. Predictably, though, those alternative allocations proved to be less successful, and so communism and socialism have advanced no further than did the divine economic right of kings in ages even longer gone by. The former communist powers do remain in the field, however, with what some might now call “state-owned capitalism.” Economists likely see no greater prospects for the quality of the performance of those economies, but they do make up in quantity (of population, in China, and of some natural resources, in Russia) for what they lack in the quality of their resource allocation; and so they remain a factor in the global economy.

Although at the end of the day an economic system need not be the product of conscious design, we could summarize it as the framework of rules, practices and customs that underlie all of the economic decisions – big, small, profound, mundane – that we make every day. Importantly, as the world has become more complex, and as economic science and economic philosophy have matured, people have thought more about economic systems and have adapted them. Some European “capitalist” systems, for example, involve significantly more of a government role than does ours – though they remain far short of China in that regard. And since the financial crisis, our U.S. version of capitalism has become far more controversial than it was, say, 50 years ago. More about the controversy later.

But back to the basic questions. What do we want of our economic system? What is an economic system supposed to achieve? Most fundamentally, an economic system needs to allocate scarce resources of labor (considered broadly, including both relatively unskilled labor and specialized skills) and capital (in all its forms, including machines, buildings, and knowledge). That allocation should be both accurate (resources get to their best uses) and efficient (the allocation should be accomplished at the lowest possible cost). If the economic system achieves that fundamental objective, then we would expect to see robust formation of new and innovative businesses, growth of productivity and living standards, and broadly shared employment and wage growth, as well as general well-being.

Over the long haul, the track record of capitalism – and especially U.S. capitalism – has been exceptional. The United States is the greatest and most prosperous economy that the world
has ever known – having assumed that distinction from its roots as a largely undeveloped frontier more than two and a half centuries ago. Of course, the society that we displaced from that position of world leadership would also have described itself as “capitalist” – it was, after all, the home of Adam Smith himself – and so capitalism alone is not the full explanation of our success. But capitalism wherever it has been practiced has reduced poverty on an epic scale. And the success of U.S. capitalism, specifically, has contributed to global growth and increased living standards. No other economic system has achieved nearly the same degree of success; in fact, by any reasonable standard, no categorically different economic system has survived. And notably, even those who most vociferously criticize U.S. capitalism uniformly stop short of recommending a fully specified but significantly or fundamentally different replacement.

Compared with a command economy, capitalism requires that individuals are free to allocate their incomes and savings as they wish, to offer their labor where they wish, and to form businesses if they so choose. These elements of personal freedom are perhaps so basic that they are forgotten, or at least under-appreciated, by many who think, perhaps without full consideration, that capitalism should be replaced.

These elements of personal freedom are also components of democracy, or at least are thought by some to drive political systems toward democracy. A person who can say “no” to orders about where he or she should work, or what he or she may or may not do with his or her money, clearly has rights – perhaps rights equal to those of the persons who would wish to control him or her. From those rights logically can flow the rights to vote and to speak freely, to attempt to influence civil society. Thus, the premises of capitalism are closely aligned with those of democracy and personal freedom, and of equality of opportunity.

On all of these grounds, we believe that U.S. capitalism has earned a special place. On bald facts, U.S. capitalism has led our nation to become the most prosperous in history, which has made epic progress in reducing poverty and other blights on mankind. But the success of the U.S. economy and nation is not a triumph solely of capitalism. Where capitalism has been allowed to function elsewhere around the world, it has facilitated progress in living standards and the reduction of poverty; but other capitalist nations have not had the same measure of success. Other attributes of the United States – including its location in isolation from potential enemies, its mineral and other natural endowments – clearly contributed. Also contributing was another family of attributes that can be summed as the character of our people. Perhaps because the settlers of America from the early part of the modern era were self-selected people who were willing to risk and strive to achieve a better life, and because those settlers have been followed by succeeding generations through the same self-selection, the American people have been uniquely successful in achieving that better life. And America has built and adhered to a moral-cultural system, build on civic institutions, which has guided American business leaders to what John Fletcher Moulton termed “obedience to the unenforceable:” adherence to a set of values – initiative, hard work, self-reliance, personal integrity, and stewardship – that established standards of propriety and behavior.

America is unique. And it is “exceptional” in that sense – not in some notion of being pre-ordained to perpetual world leadership, regardless of future behavior. We believe that our future success as the world leader will depend upon our willingness to maintain our fundamental principles, including personal freedoms and rights – which flow from our
capitalist economic system. Our rights are essential not only because they maintain our national spirit from within. Those principles also give us standing when we seek to establish standards of behavior in geostrategic terms as well as in international trade and finance. Thus, we must rededicate ourselves both to the competition that flows from capitalism, to maintain our prosperity, and to the principles of freedom, equal rights, and ultimately democracy that are enhanced by the workings of capitalism as well.

We were motivated to pursue this project in part by the challenges to U.S. capitalism from some who we believe misunderstand capitalism’s strengths and weaknesses, and the obligations that it imposes on all of us to make our economy succeed. But we do not believe that a good outcome of such a debate over the merits of capitalism would be a victory for one side and a silencing of the other. Rather, the best outcome would be a meeting of the minds: an economy, a nation, and a society in which all sides – whatever their differences – ultimately pull together for the benefit of all. Capitalism requires competition, which inevitably has relative winners and losers. But our system should provide equal opportunity, and reward effort. It should yield market-based, widely accepted outcomes. We would then have lesser inequality not because those outcomes are forced, but because the capabilities and opportunities of all in our society are greater. More-capable workers, investors and entrepreneurs would yield a nation that is not only more equal in providing opportunity, but also more prosperous and more satisfying and uplifting to all Americans.

But duly acknowledging the theoretical and historical merits of U.S. capitalism, how has capitalism performed in recent years, especially since the financial crisis? Here, the scorecard is far more equivocal. The capitalist world has been rocked by the greatest economic and financial crisis in almost a century. In fact, perhaps the best that can be said for this episode of capitalism’s history is that it did not fully plumb the depths of the Great Depression. Was this colossal downturn the fault of “capitalism,” though?

Capitalism cannot and does not pretend to eliminate either poor judgment or malfeasance. It can only incent good on both over the long run. Clearly, many economic actors, both public and private – some with considerable responsibility and presumed financial sophistication – simply failed to recognize the critically over-inflated bubble, and even its cause. And equally clearly, some others took advantage of persons of lesser sophistication. No one should accept such failings, particularly given that they had such extraordinary ill consequences. But even in good times, some economic actors fail to perceive competitive threats, or simply miscalculate; and as a result, businesses fail and employees and investors are hurt. These are the risks of the market; without the risk of money being lost, money cannot be made. People of ill will may take advantage of others. Public policy can be poorly calibrated, can bear unintended consequences, or can fail to foresee changes in circumstances. And these failings, because there always are humans of differing ethical values, have occurred in command economies as well as under capitalism. The alternative economic system that bestows universal wisdom and perfects human nature has not yet been found. The best course for our nation, by all evidence, is to pursue and enforce fair rules and common ethics, not to search for some fundamentally different economic system that promises to solve all of our financial and social problems for us.

But even beyond the financial crisis, some would raise questions about the recent performance of capitalism. Again, on the most basic level, a fundamental function of our
economic system is to allocate capital to its best uses at the lowest possible transactions cost. As to the accuracy of the allocation of resources, critics would say that U.S. competitiveness in goods production, and perhaps even services delivery, has been declining.

As to efficiency, which is to say the cost of allocating the resources, some would argue that today we spend much more to allocate our resources relative to the amount of resources that we allocate than was true in the past. Was that because of market power? Or is that because with globalization and escalating technology, the task of allocating investment is more complex? Ever-more-complex financial instruments have been marketed. But is that merely an attempt to securitize repeatedly the same “real” economic activity, to get a cut of the action with every additional financial transaction; or is it rather the development of ever-more-finely-tuned hedging devices for the benefit of goods-and-services-industry participants in these markets, perhaps poorly steered by inefficient regulation? We expect to explore this question – about “excess financialization” – in much more detail over the course of this project.

And finally, economic performance in the most generic sense has been below-trend since the financial crisis. Historically, deep recessions have been followed by steep economic recoveries, but – per the warnings of economic historians who have studied past financial crises – this recovery has been disappointingly languid. Aggregate economic output has lingered below the pre-crisis trendline. Is this because of a drop in trend productivity growth (a volatile and hard-to-measure indicator), a so-called “secular stagnation,” which might be enduring for some extended time? Or is it simply a failure to achieve a full recovery from the financial-crisis-driven recession – a recovery which might still arrive once the wounds of that crisis on both the financial system and on consumers’ and producers’ psyches have finally healed? Or is it due to misguided government meddling in markets?

The sub-standard U.S. economic performance, in both the financial crisis itself and the recovery from it, has disillusioned and demoralized many Americans. They would include a population of idled and underemployed workers with a strong perception that the game is rigged – that they are under-rewarded for their efforts (or their willingness to exert effort), while others either are grossly over-rewarded or even have profited from malfeasance. These disaffected persons would say that the reason for their economic suffering is the failure or malfunctioning of the U.S. capitalist system. Sophisticated analysts may argue that the weakness in wages, employment and economic output is caused by cyclical factors, and add that an impending arrival of the long-delayed economic recovery, forestalled by the deep wounds in the financial system, will right the balance between the earnings of rank-and-file workers and the salaries and bonuses of investors and players on Wall Street, who profited from temporary and extraordinary opportunities as the economy turned around. Regardless of the cause, consumer and citizen morale has declined, and so the tone of both civic and economic life is soured – perhaps to the point of serious damage. Consumer demand, labor

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supply, worker commitment, and civic engagement all suffer. Whatever the cause and whether particular critics are right or wrong, we need a better-functioning economy and a populace engaged and with confidence in it.

U.S. capitalism has succeeded at least in part because of remarkable public support and long-term results. The abatement of public support for capitalism today is thus a matter of considerable concern. Its coincidence with associated problems, such as the impending crisis in public finances, only aggravates that concern. A nation lacking public consensus and cohesion will have only more difficulty achieving painful compromise that must entail sacrifice by many particular interests for the good of the whole.

It is all the more important, therefore, that business leaders demonstrate capitalism’s proper role in harmonizing the individual interests with the common interest. The business community needs to understand and explain the strengths and limits of capitalism – in job creation, productivity growth, and ever-advancing prosperity. Business leaders need to promote growing prosperity, broadly shared – as CED has advocated from its earliest days – through both business and public policy. It is in no one’s interest to claim a growing share of a shrinking pie; better that the pie should grow for all, so that everyone can walk away with more in absolute terms. And at this time, safeguarding our prosperity will require some difficult choices, which business must explain and lead.

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 any controlling premise – such as, for example, 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 and thereby ensure its sustainability.

The recent economic weakness had multiple causes, and advancing the economy in the future will require multiple remedies. In this project on sustainable capitalism, CED will take a comprehensive view of what the nation must do to make capitalism and the economy vibrant again. CED’s research program 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. The topics that we now contemplate include:

The first topic that we take up is “crony capitalism:” the tendency of incumbent interests – including, but not limited to, businesses – to protect their own interests by thwarting market forces – obtaining enactment of public policies that restrain their current and potential competitors, sometimes other incumbents, sometimes new and young innovators who lack the accumulated profits needed to compete in campaign finance, lobbying, and otherwise influencing public policy. Could the growth of such 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 business-government dependencies 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 global companies – with multiple loyalties – 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?
Is there any validity to complaints about the failure of corporations to balance the need of their various “constituencies” for the sake of maximizing profits?
Does business bear some responsibility for income inequality? Whether it does or not, what, if anything, can business do to alleviate the problem?
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.

Following are more-detailed discussions of some of the papers that we contemplate.

**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.
The term “crony capitalism” has become a part of our vernacular to describe this phenomenon, and so we use it here. However, it also is to some an indictment of all of the business community, or of capitalism itself; and that is by no means our intent. We emphasize that U.S. business has over the long term produced tremendous improvements in income and living standards for the population at large; and that capitalism must, for that reason, be made sustainable. But we recognize that a small minority in the business community did cause enormous harm in the course of the financial crisis. We will describe this gradual and perhaps growing tendency of private interests, including but not limited to business, to try to mute or circumvent market competition by influencing the policymaking process in Washington and in state capitals and local governments around the country. Our goal is to raise awareness of this trend, which may have grown so gradually as to attract less attention than its remedy would require.

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 a substantial source of revenues for lobbying comes from incumbent interests. We will attempt to determine whether there is reason to believe that, on balance, lobbying by these incumbent interests is negatively impacting new firms and other innovators in 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 countries. 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 leaders to focus on short-term results to the detriment of 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 the way managers and executive are compensated and incentivized in these alleged problems?

Do corporations appropriately balance the needs 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 disenchantment 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 through 2017 will celebrate our 75th anniversary with a rededication to our strong 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 and other market participants, 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.
With these efforts, we seek to bring capitalism fully on track, to make it sustainable, and to unite Americans of differing persuasions behind the core principle that our economic system can work for all of us. We see no higher task than to achieve CED’s ideals (and capitalism’s) – growing prosperity, broadly shared – as we approach CED’s diamond anniversary, and in the decades beyond.