Capitalism’s Evolution

As we begin to think together about how best to restructure our economy, this essay is a background piece to help us understand that capitalism is not monolithic, that the extreme, free-market capitalism of the last generation is a deviation from capitalism's historic evolution, and that there are concrete, practical, and (most importantly) just alternatives to our current economic system.

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The current collapse of the global economy puts before us a critical question: Is the current economic system fundamentally sound, needing only minor correctives, or has it reached its limits, requiring fundamental rethinking? It is my contention that the unconstrained free-market ideology imposed on American economic thinking for the last thirty-five years has been a hijacking of the evolutionary development of capitalism that could otherwise offer us a just, sustainable economics.

The word “economics” comes from two Greek words, oikos or “house” and nomos, “one who manages,” so etymologically economics has a broad meaning, something like “care for the household.” If the purpose of our economy is to care for our common household, what are the values that should guide our innovation? I suggest that adequate care for the national household must provide at a minimum:

- a job for everyone who wants one on which one can support a family
- good education for each of our children
- adequate universal health care
- basic security for old age or in the event of unemployment or illness, and
- environmental sustainability.

A Brief History of Capitalism

American capitalism as it evolved over our history was well on its way to realizing such a vision. To understand the evolution of market economics, the forced detour of the last generation, and how we might get back on track, a short historical tour of capitalism is helpful.

Before the science of the free market was understood, economists of the time conceived of the world’s essential economic problem as scarcity: There wasn’t enough food, enough shelter,

enough transportation, or enough education to divide among the world's population and have everyone get an adequate amount. (Yes, even then, distribution of the resources that did exist was probably a more important problem, but scarcity became the dominant issue for economists.)

In 1776, Adam Smith, the prophet and champion of capitalism, published The Wealth of Nations in which he laid out the fundamental principles of economic competition within a "free market" to maximize efficiency as follows.

1. The economic system works best if each person pursues his or her own self-interest, ie, the greatest profit.

2. The profit motive drives economics. The only basis for making economic decisions should be what brings the greatest monetary profit.

3. In order to make economic decisions, everything must have a price. Money provides the measuring rod of economic value.

4. Decisions about whom to produce things for are determined by supply and demand, by income relative to others. Private wealth determines the distribution of goods and services.

5. Wealth is primarily private property that, within certain legal limits, one can do with as one will.

Smith recognized that from a traditional moral point of view, these assumptions were suspect, but he believed that the free market would automatically transform self-interest into the greatest good for the greatest number of people, "as if by an invisible hand." And he was certainly correct that capitalism would become an extraordinary engine of economic growth. It was, and remains, simply the most efficient system yet implemented for creating wealth; given that the most important economic problem of the time was scarcity, capitalism did appear to live up to its promise of the greatest good for the greatest number, radically increasing the average material standard of living—even, it has been argued, for the poor.[1] Since the end of the Second World

War and especially since the collapse of Soviet Union communism beginning in 1985, capitalism has had no serious challengers. English Prime Minister Margaret Thatcher famously declared, “There is no alternative.”

Why has it been so effective? I would underline four general reasons.

1. Following Smith’s first principle, capitalism liberates from moral opprobrium one of the most powerful human drives: self-interest. Working for one’s own economic benefit creates a powerful incentive to work hard over the long term. While community solidarity or altruism can evoke great bursts of energy, the historical record is not kind to such experiments on a large scale or over the long run. Like it or not, self-interest is a powerful motivator.
2. Following Smith’s second and third principles, capitalism’s price mechanism is an extraordinarily efficient information management system that organizes essentially infinite amounts of data for straightforward decision making. Any economic system requires many decisions in each firm that must take into account similar decisions in many other firms: Which firm should get what supplies? What should workers get in return for their labor? When should a firm expand? When should it take on new technology? Who should get the products? Looked at as an entire system, those billions of individual decisions become an unbelievably complex and interwoven web that overwhelms, for instance, a large centrally planned economy. But capitalism’s price mechanism organizes this information overload in detail and then farms out the decisions to millions of individual actors, who need ultimately heed only one variable: their own self-interest. Capitalism simplifies and then decentralizes decision making.
3. Capitalism has been so productive because for the last several hundred years the global economic system has had available to it natural resources that were, for practical purposes, inexhaustible. Capitalism stimulated the technological capacity to utilize those resources while there was only limited recognition that they were, in fact, limited and non-renewable. In this environment of abundant, vastly underpriced resources,[2] capitalism’s efficiency naturally flourished. Capitalism’s extraordinary productivity, for instance, has depended upon the extraction of the limited resources of oil, natural gas, and coal unhampered by ecological constraints. That unique era in human history of “unlimited” natural resources is now over, but that does not change the extraordinary capacity of capitalism over the past several hundred years.
4. Capitalism is not a monolithic economic system but a malleable framework capable of adapting to local conditions and evolving in the face of its weaknesses. While obvious, capitalism’s capacity to evolve and improve has frequently been hidden amidst the clamors of ideology.

The Evolution of Capitalism

Adam Smith acknowledged three essential pre-conditions to efficient market competition. Those essential conditions, however, can only be guaranteed by the laws of the larger society,

so evolution was necessary to prevent what have become well recognized classes of “market failure”—imperfect competition, inadequate information, and externalities. A completely unconstrained market would soon run off track.

Imperfect competition

In his original work, Smith assumed a market comprising many small sellers and many small buyers. He understood that the market would become inefficient if any producer or buyer were big enough to influence pricing in the market. Yet the economies of scale inherent in many kinds of business activities along with the political power of wealth lead inevitably under free-market conditions toward larger and fewer companies, which then hamper competition and lower the efficiency the economy. The well-recognized remedy for monopoly is antitrust legislation to break up monopolies or oligopolies that endanger the public good. President Teddy Roosevelt, for instance, is famous for his “trust busting” of the oil and railroad industries of the early twentieth century.

Inadequate Information

Smith also recognized that if some buyers and/or sellers had better information than others, the market would be distorted and become inefficient. The resultant transactions were also likely to be unjust and potentially dangerous. A stockholder who is also a board member of a company will have information about the company (eg a recent discovery likely to double profits) that is unavailable to others, endangering the fairness of the stock market and discouraging participation. A car manufacturer who secretly scrimps on expensive safety provisions will be able to sell those cars more cheaply, but the competition with other manufacturers who do not take unsafe shortcuts is not fair and the results potentially catastrophic. The remedy for this kind of “information asymmetry” is government regulation, for instance, prohibiting “insider trading” or requiring product safety standards.

Externalities

Smith was aware that the market would not be efficient unless all costs were included in a product’s price. An externality is a distortion of the market that occurs when someone other than the buyer or seller suffers a cost (a negative externality) or receives a benefit (a positive externality). When a manufacturer pollutes a river, the costs associated with using the river as a dump are externalized to the people downstream, so the manufacturer (and consequently the consumer of the product) is not paying the full cost. Care for the river will not be factored into the economic equation because someone else is paying for it, in this case the people downstream drinking the polluted water or paying for its purification. The product appears to the market cheaper to produce than its real cost to society, removing any incentive to environmentally conscious manufacturing. Indeed, in a tight market even an environmentally conscious manager will not be able to spend more for “clean technology” without pricing his

product out of the market unless all other companies are also forced to do the same. The remedy for such externalities is taxation or regulation to require the entire industry to internalize the costs.

An especially important form of negative externality occurs when costs are pushed off to the future. Economists recognize the human psychological tendency to “discount” future events. (For instance, people continue to smoke or fail to exercise because the future gains or losses are not as important to them as present gains or losses.) To take this into account, economists discount future costs when figuring out economic efficiencies. Generally, costs beyond 20 – 25 years in the future are not counted at all. Accordingly, the free market simply cannot take into account gains or losses (like the impact of global warming or the permanent loss of species) that are externalized to future generations. Not only are the costs externalized to others, but those (future) others are not even here to organize resistance. The same phenomenon makes it impossible for free-market capitalism to appropriately price permanently limited resources. The amount of oil in the earth is finite. If one considers a time in the future when there will not be enough oil even for the production of absolute necessities, it is obvious that today’s fuel costs that make it affordable to vacation in Nepal are drastically underpriced. Our economic system has not yet evolved to recognize those realities, but it will have to if we are to survive.

A positive externality occurs when the benefits of a transaction accrue to people who do not have to pay for it. If schools are privatized, for instance, the students (or their families) must pay for the cost of education. But an educated populace brings many advantages to the people in the wider society (for instance, an educated electorate and a lower rate of violent crime) who do not have to pay for the private education. Economists know that, because those who receive the benefit are not paying the cost, positive externalities result in too little of a desired good being produced. The closer society moves toward exclusively private education, the more the society will suffer for the lack of an educated population. The remedy that has evolved in capitalism is the public provision of basic education, police protection and national defense funded through taxes required of everyone.

Economists recognize these market failures because they interfere with market efficiency. But economists define efficiency a bit weirdly: A market is completely efficient when no person can be made better off without making another person worse off. But “efficient” is not the same as “just” or “desirable.” The market would be perfectly efficient, for instance, if one person owned all the wealth, and everyone else had none. (In order to make anyone better off the owner-of-everything would have to become worse off.)

When scarcity was society’s primary economic problem, it made some sense to give this kind

of efficiency almost absolute authority. But equitable distribution has overtaken scarcity as the economic system's most important problem. Again, capitalism has had to evolve.

Extremes of Inequality

Unregulated capitalism leads inevitably toward extremes of wealth and poverty, which are not only unjust in themselves but also destroy the foundations of democracy. The wealthy develop inordinate power in capitalism that allows them to control politics, marginalize unions, set prices and much more. Given the underlying theoretical structure of capitalism, anything else would be very surprising. Smith himself recognized that an unregulated system would give extraordinary benefits to the owners and landlords at the expense of the vast majority of the human population.

This inequality becomes an important political problem, however, once it is obvious that there is enough wealth for everyone to have enough if it were distributed more equitably. In capitalism money wealth completely determines the distribution of even essential goods and services. Aside from charity, those without money have no access to what they need or even a vote in determining what is produced. The 25,000 children who die every day from hunger and preventable disease do not have the dollar "votes" to counter the desire of the wealthy for, say, private yachts.

Although this degree of inequality is not a "market failure" in the technical economic sense, it is a problem. The remedy has been capitalism's evolution to include progressive taxation and social welfare programs—such as Social Security, Medicare, unemployment insurance, and the Earned Income Tax Credit—to redistribute some portion of our common wealth to those who otherwise might not have enough. Progressive income taxation—in which the wealthy pay not only a greater amount but also a greater percentage of their income—is now routine in Western democracies. (The first US income taxes applied only to incomes above $50,000 [adjusted for inflation]).

Market collapse

The recent failure of the financial system points to another failure that has pushed the evolution of capitalism: recurrent market collapse. An unrestrained free-market economy has always been subject to booms and busts harmful to the general welfare. As a result capitalism has evolved to include government policies to restrain these free-market mood swings. The Federal Reserve has the power to modify interest rates in order to slow down or speed up the economy as needed. The federal government can also smooth out the economy's lows and highs by increased spending (to stimulate the economy) or increased taxation (to slow

it)—so-called Keynesian economics.

Local Community Capitalism

Probably the most important “evolution” of capitalism is that most small entrepreneurs do not really abide by Smith’s strict definition of self-interest (ie the greatest profit). Rather, local owners tend to adapt to community values. When I was a private physician in a small community, for instance, one the doctors owned our clinic, which was, technically, I suppose, a “capitalist enterprise.” Yet, we lived in the same community and would not have considered turning away patients who could not afford to pay for care or charging full fare to others with marginal incomes. The welfare of the community was part of our “bottom line.” Business people everywhere make business decisions for non-monetary, community reasons. The owner of a local mill is going to think twice about polluting the river his children swim in (and he will be very susceptible to community pressure if he does not). Local communities may not begrudge the banker a certain wealth, but if she earns too much and pays her tellers too little, the banker will discover (well before she reaches the 400 to 1 salary ratio of current CEOs to workers) that there are certain insistent community mores. There is no “unconstrained free market” in a local community.

What is crucial to notice is that “capitalism” has never been one static system. It has evolved over several centuries to correct its weaknesses and bring it more closely in line with society’s values. Scarcity is no longer the dominant concern it once was. (Indeed, sophisticated advertising had to be developed beginning in the mid-twentieth century to entice American consumers to buy products we otherwise would not have wanted.)

Our society has recognized that government must limit through extensive regulation and taxation the extraordinary, but potentially destructive, power of the free market. The Federal Reserve and federal spending modulate the economy; environmental legislation requires internalization of appropriate costs; monopolies are broken up; consumer safety laws are legislated; and government provides police and fire protection, basic education, and national defense for everyone. Completely free-market capitalism has rarely, if ever, existed. Government has always regulated the economy in order to move toward society’s deeper values: full employment, an adequate standard of living for everyone, universal education, universal health care, security in illness and old age, protection of the environment, and so on.

And a Regression

Beginning in the late 1960s, however, the direction of capitalism in the United States began a significant shift. Due to inflation and government spending accompanying the Vietnam War,

Keynesian government intervention in markets lost favor, and a school of economists led by Milton Friedman pushed for freeing the market from “government constraints.” The freer the market, they argued, the more efficient the economy.

Large, public corporations contributed to the pressure for change in economic policy. Unlike the traditional locally owned businesses, the corporate structure meant that the owners (the shareholders) increasingly had no relationship to the communities affected by the corporations. Due to Supreme Court decisions, corporate management is required by law to serve only the financial interests of the stockholders unless there were specific stockholder resolutions to the contrary (which almost never succeed). As a result, the extreme “financial-self-interest-only” of Smith’s first assumption dovetailed with the argument against government constraints to push for less regulation, lower taxes, and fewer social programs.

The problem has been that—from an evolutionary point of view—this movement toward unconstrained capitalism has largely been a regression away from real “care for the household.” Accordingly, the well-known problems with raw capitalism have reappeared and created havoc. Monopolies and oligopolies have dominated markets, environmental problems (including global warming) have deepened, the financial industry has threatened recurrent market collapse requiring huge federal bailouts (eg the Savings and Loan crisis of the twenty years ago or today’s economic crisis), inequality has skyrocketed, and the average American is working much longer hours and is deeper in debt.

As a result, there has been a growing concentration of political and social power among the wealthy that feeds the vicious cycle of lower (and far less progressive) taxes, fewer social programs, and deregulation.

Unfortunately, “bad” capitalism drives out “good” capitalism. Unregulated companies are more efficient; they can produce goods more cheaply; they will force other companies to compete on their terms or die. The country with the freest markets will, in the short run at least, force others to scuttle their socially desirable controls over the economy, just to survive. Capitalism stops evolving and begins to devolve, which has been very good for the rich and powerful and not so good for the rest of us. Capitalism ceased its movement toward becoming a pragmatic way of organizing the economic system to benefit everyone and became instead an ideology to enrich a very few.

The collapse of the financial industry and the resultant severe recession have made it

obvious: Capitalism requires adult supervision. This is not a new or controversial recognition. Since its founding, capitalism has, like almost everything else, had to evolve and grow in order to care for the human household, the true purpose of any economic system. During the last thirty-five years, a few of the big kids have locked the adults in the closet and bullied everyone else. It’s time to reclaim our household.

A vision for the future

So what is our vision for an economic future that will move us toward our real values as a society?

Structure of businesses

Some things should not change much at all. Small businesses are 99.9 percent of the 27.2 million businesses in the country. [3] Local people own the vast majority of those. While smallness and local control are not panaceas and some of the measures outlined below will remain important for all businesses, community values tend to be structured into small, locally owned businesses.

How might we restructure the remaining 17,000 large businesses—especially those publicly owned by shareholders—to remedy the current push toward raw, unconstrained capitalism? One response is to remember the long-recognized need to break up monopolies and oligopolies. Whittle corporations down to size. A second remedy (already in place, for instance, in Germany) is to require that all corporate boards include representatives from employees and consumers who are specifically tasked with looking out for the common good, not just the financial bottom line. A third remedy—already in place in even very large US businesses—is employee ownership of the company. This allows for workers to share in the profits and, because workers are usually local, look out for community values. Wendell Barry and many others have advocated for a far more local economy in which only absolute necessities are imported, which would decrease the size of companies and make them more responsive to their communities.

Care for the Household

Care for the human household requires, at a minimum, an environmentally sustainable economy, jobs on which a person can support a family, a high level education for everyone, universal health care, and basic security for illness or old age. The overall vision is of a market economy guided by a democratic society’s deepest values expressed through government policies of taxation and regulation.

Perhaps the most important recognition is that the free market cannot protect the environment and move us toward a steady-state, sustainable economics unless governments at all levels requires companies to internalize the costs of production that they externalize to others under the usual dynamics of raw capitalism. The simplest method is government regulation that requires every company to develop and install “clean” technologies. An alternate strategy is to tax environmental damage and use the revenue to clean up the environmental mess. Usually a combination of regulation and taxation is most efficient. An even more interesting proposal is to establish non-profit trusts to “own” and be responsible for the atmosphere, the rivers, or other natural resources. These trusts are then legally mandated to prevent pollution, protect the natural resource for future generations, and sell the rights to companies for limited current exploitation. The trusts would determine—consistent with their legal mandate to protect the environment—how much of the resource (eg, clean air) would be “sold” to a company thus forcing it to internalize an appropriate cost. The market would then determined the actual money worth of the resource. The trusts would first use the (presumably vast) income generated for clean-up and then pay “dividends” to the poor and working class in order to a) balance the increase in costs resulting from companies internalizing the real cost of their use of common resources and b) decrease income inequality. [4] (The Alaska Permanent Fund that returns dividends to every Alaska state resident from the sale of oil is a well-known, well-functioning example.) Cap-and-trade proposals are a rudimentary form of this concept. If all companies are forced to pay the costs of cleaning up their messes, then not only will the messes get cleaned up but market forces will also lead to cleaner technologies. Similar mechanisms can be used to preserve resources for future generations.

The power of workers to bargain with their employers must be strengthened so that workers take home a fair share of increasing productivity. The increasing political power of the wealthy over the last thirty-five years has steadily eroded the power of American unions (in part due to weakening government regulations, in part due to highly successful anti-union propaganda), despite the fact that over half of all workers would prefer to join a union. The proposed Employee Free Choice Act, which would make it possible for a union to be certified if a majority of workers signed the appropriate cards, is an important first step.

Redistribution of Income

During the last presidential campaign Senator McCain consistently attacked then-Senator Obama for wanting to redistribute income. Neither candidate seemed willing to acknowledge explicitly that income redistribution is as American as apple pie. Recovering the more equitable income distribution from thirty-five years ago is a second vital evolution in our economic system. In the thirty years immediately following World War II, progressive taxation, high levels of unionization, and social welfare programs meant that the increasing productivity in our country was broadly shared across all income groups, with each income quintile roughly doubling. Over the last thirty-five years, however, virtually all of the increased productivity has gone to the very

wealthy while lower-income wages have actually dropped.

During this recent turn toward free-market capitalism, tax rates have been so modified that they are in practice no longer actually progressive. If all taxes are considered (eg sales taxes, payroll taxes, property taxes, income taxes), the tax rate is about the same for everyone: generally the very rich pay a lower percentage, the middle class pay the highest and the poor somewhere in the middle.[5] This is primarily a result in changes in income and capital gains tax rates since the 1970s. During the 1950s, for instance, the marginal tax rate[6] on high income was over 90%; today it is 35%. The capital gains tax was 50%; today it is 15%. We must return to a system of progressive taxation.

The argument that such highly progressives taxes would punish successful entrepreneurs overlooks the extraordinary contribution that tax-supported public structures play in any wealth-building. Physical infrastructure, a well-functioning legal system, a monetary system, public education, and a host of other resources now (appropriately) available to everyone free of charge are what make possible the creation of wealth. Supreme Court Justice Oliver Wendell Holmes commented that taxes are the price we pay for civilization. They are also the price we pay for being able to create wealth. During Republican Dwight Eisenhower's 1950s administration, our economy seemed to function just fine with truly progressive taxation, and the increase in national productivity was shared over all income classes.

What should be done with the increased tax revenue? While some programs of income redistribution—like the highly successful Earned Income Tax Credit—actually take tax money and give it to people with low incomes, most redistribution is actually through services. President Obama's proposed universal health care, for instance, is intended to provide everyone with access to health care.[7] Although the program would be available to everyone, it preferentially benefits those who would not otherwise be able to afford coverage. Vast improvement in public education and tuition assistance so that everyone academically qualified can attend college will further provide real "care for the household." Unemployment benefits must be improved so that those who lose their jobs can have a basic income while searching for work. And the Earned Income Tax Credit must be expanded so that all working people can support their families. We know how to decrease inequality while maintaining the incentives of competition. Every other Western democracy has already instituted similar programs.

A third state intervention is increasing regulation to prevent activities harmful to the general society. Stronger anti-monopoly laws need to be re-established and enforced. Regulations peculiar to certain types of industry (eg, the financial industry) need to be developed and firmly imposed so that those industries serve not only their investors but also the public interest.

The opportunity inherent in the current crisis is that the failure of raw capitalism is now in plain view. The emperor has no clothes. Populist anger toward the way the economic system has been manipulated to benefit the wealthiest is high. During such unusual times as these (the Great Depression was the most recent), there is a real possibility of mobilizing that vast majority of people who would benefit from a more evolved form of capitalism. Political change becomes not only possible but probable.

[1] This argument, made with considerable confidence by free-market apologists, depends upon unprovable assumptions about the degree of world poverty before capitalism.

[2] How much more would oil cost if future generations were able to bid on the oil that will soon be gone? How much would electricity have cost if electric generators had had to pay to neutralize the carbon they have been putting into the environment?

[3] US Department of Commerce, Census Bureau, 2007, http://www.sba.gov/advo/stats/sbfaq.pdf.

[4] This alternative is discussed in considerable detail in Peter Barnes's book-length Capitalism 3.0 available without cost for download on the Internet: http://capitalism3.com/downloadbuy. The book itself—published under a Creative Commons License—is an experiment in alternative economics.

[5] Johnston, David Cay (tax reporter for the New York Times), Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich—and Cheat Everybody Else, New York, 2003, p 13

[6] The "marginal tax rate" is the tax rate applied to income over a certain amount. In 2009 the rate for the first $8350 of anyone's taxable income is 10%. The rate for anyone's taxable income

between $8350 and $33,950 is 15%. The rate for each segment of income keeps increasing. The marginal tax rate for all income over $372,950 is 35%.

[7] I would, however, argue strongly for extending to everyone a Medicare-like program that will fund medical care through taxation, the so-called single-payer plan.