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Good Capitalism, Bad Capitalism: What Is a Market Economy and How Can It Deliver?

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Article at a glance

- The traditional approach to studying economic growth overlooks the importance of individuals and individual firms.
- Market economies are not monolithic – there are four different types of capitalism (oligarchic, state-guided, big-firm, and entrepreneurial), each with different features and implications for growth.
- Entrepreneurial capitalism is the most effective driver of economic growth because it provides opportunities for new firms to innovate and create new markets.

This article is based on the remarks delivered by Robert Litan at “Democracy that Delivers: An International Conference on Improving the Quality of Democratic Governance and Economic Growth,” held in Washington, DC on October 27, 2009. The remarks were inspired by Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity by William J. Baumol, Robert E. Litan, and Carl J. Schramm, available from Yale University Press.



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The Story of Economic Growth

What is a market economy and how does it maximize growth? Nobel Laureate Robert Lucas said that once someone begins to focus on growth, it is hard to think about anything else. Economic growth is the engine that drives improvements in standards of living for people around the world. The purpose of any economic system should be promoting economic growth and thus advancing those standards of living.

Economic history shows that there was a long hiatus after the early economists Adam Smith and David Ricardo when there were almost no economists focusing on economic growth over the long-run. True, macro-economic stabilization came to the fore during the Great Depression and of course, John Maynard Keynes wrote about how to stimulate aggregate demand. But the focus of Keynes' work was not on the long-term growth of the economy. There was no resurgence of that interest until Robert Solow's work in the 1950s, which eventually led to a Nobel Prize.

Still, Solow's work did not vault economic growth into the pantheon of the most important subjects that economists study. The subject remained a minor concern until the famous Summers-Heston Penn World Table databases were made available and economists were able to do the thing that they love to do most, which is to use a set of economic data to explain trends and outcomes – in other words, run regressions. They were able to use income data, appropriately adjusted for differences in purchasing parity, and compare it to every kind of socio-economic variable one could want. Economists since have made an industry out of running such cross-country regressions to try to figure out the magic recipe for growth.

These recipes have encouraged the so-called 'bake the cake' approach to economic growth, which is the notion of taking some ingredients – such as capital, labor, knowledge, innovation, or institutions – putting them all in a bowl, and mixing up growth. Using different coefficients or combinations of ingredients, depending on the

time period and on how many other ingredients are in the mixing bowl, economists came up with many different formulas. That is basically the way economists thought for a long time about economic growth.

It is not, however, the *only* way to think about growth. After all, economies consist of individual people and individual firms. If there is one thing to learn from economic history, it is that aggregate growth arises from the growth of firms; economies are nothing more than the aggregation of the firms within them. Thus, the really interesting story in economics is what accounts for the formation and the growth of individual firms.

There were seeds of interest in this notion of growth among economists as long as 30 years ago. Examples include Richard Nelson, who now teaches at Columbia University, but who was also a professor at Yale University and Sidney Winter, who wrote a pioneering book 30 years ago on the evolutionary approach to firm formation and growth as a basis for understanding economy-wide growth. More recently, William Baumol and Nobel Prize-winning economist Edmund Phelps have focused on the formation and growth of firms as the engine for economic advancement.

The Kauffman Foundation has been one of the leading funders of this kind of growth-related research in the world, and much of its tradition of in-depth and critical analysis is now embodied in the book *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity*, which I had the good fortune to co-author with William Baumol and Kauffman's President Carl Schramm.

Good Capitalism, Bad Capitalism

The premise of the book is that market economies or capitalism are not monolithic – although there has been a tendency to think so after the Berlin Wall fell. The perception was, at least in the United States, that capitalism had won and communism had lost and that was the end of the story. There was little discussion about the various forms that capitalism took. Out of the world's

roughly 190 countries, 188 recognize private property, (except Cuba and North Korea) but all 188 look very different, even controlling for differences of per capita income.

Good Capitalism, Bad Capitalism attempts to bring order to this chaos. Its four typologies of capitalism are not meant to suggest that every economy fits perfectly into a particular category. The typologies are mental constructs – some economies are more one kind than another, some straddle multiples, and many economies have elements of all four kinds of capitalism.

Oligarchic capitalism

Oligarchic capitalism, where resources and power in the economy are concentrated in the hands of a few, is without question bad capitalism. Examples of oligarchic economies include Russia, oil-rich Middle East countries, and many states in Africa and Latin America. The objective function of oligarchic capitalism is not to maximize economic growth but to maximize the welfare of the powerful who capture most resources and often divert their profits to offshore bank accounts. The objective function of these leaders does not coincide with advancing the welfare of their people. Marginal interest in economic growth may arise only as a political strategy to keep constituents happy enough to not revolt.

There are huge inequalities in income levels under oligarchic capitalism. It is no accident to find huge degrees of informality in the markets in these countries. Often, those in power and with money do struggle to keep property rights or the kinds of accoutrements of market economies we see elsewhere from the rest of the population. If the people acquire these powers, they can challenge the economic and political dominance of the those in charge.

State-guided capitalism

Although the name provides some potential confusion, state-guided capitalism is not communism. In communism, the state owns the

means of production. In a state-guided economy, means of production are privately owned, but the state guides resources to the industries most likely to be successful, for example, through state ownership of banks. Chinese banks control substantial portions of the resources in the economy while in India, 75 percent of the banking system is controlled by the state. That is clearly one way to guide an economy. Other tactics include import protection, export subsidies, regulatory incentives, and more.

The basic premise of state-guided capitalism is that the state knows what it is doing and it can decide how to get there. In very limited circumstances, state-guided capitalism can be effective at producing growth, for example, in the rise of Southeast Asia. As the region was far behind the global economic frontier, it looked to the economies *at* the leading edge – the United States, Europe, and Japan – as models. The governments imported the technology for manufacturing, applied educated low-cost labor, and started trading. State-guided capitalism systems often lead to rapid early growth, but their likelihood to eventually stall is high. In the case of Southeast Asia, some countries (like Singapore) have almost caught up to the front, at least in terms of manufacturing.

The question becomes, once they are close to the frontier, can state bureaucrats figure out where to put the money? That is the Achilles' heel of state-guided capitalism. It is also why – we argue – Southeast Asia suffered as it did in the financial crisis. The state put too much capital into industries that later had too much capacity and descended into crisis. There is a limit to state-guided capitalism, and Singapore will be its acid test. Singapore is still actively engaged in guiding the economy toward biotech, while at the same time encouraging entrepreneurship. Singapore will be a true-life experiment in practicing state-guidance close to the frontier.

Big-firm capitalism

The third kind of capitalism – big-firm or managerial capitalism – makes up the economies of Western Europe and Japan, and of post-World War

II United States. Harvard economist John Kenneth Galbraith described it as a new industrial state where big steel, big auto, and other large corporations were checked by “countervailing powers” of big labor and big government.

There is great benefit to big-firm capitalism: economies of scale, financial and human resources for research and development, and of course, capital to deploy. Due to their size and their ability to diversify resources, they can establish research and development centers such as the famous Bell Labs or Xerox PARC. As innovation becomes routinized, big-firm and managerial economies become experts at incremental innovation – America’s great strength for much of the 20th century. Today, Japan and Germany today have similar routinized innovation patterns.

Yet a significant weakness of big-firm capitalism is its discomfort with radical innovation. Almost by definition, big firms do not want to invest in new products or services that can make their current profit centers obsolete. This leads us to the final form of capitalism.

Entrepreneurial capitalism

The final type of capitalism is entrepreneurial capitalism where economies are dominated by new firms. The advantage of new firms is their independence. Founders do not often have a vested interest in the *status quo* and thus are more likely to commercialize the disruptive innovation that is responsible for the lion’s share of long-run economic growth.

Consider the modern inventions that have been commercialized and radically changed our lives: the steam engine, electricity, the automobile, the airplane, air conditioning, computers and software, the Internet. These innovations – and the resulting industries – were created by entrepreneurs, not by established firms, as entrepreneurs are free to try something new. Do we then conclude that an economy can rely only on entrepreneurs? Unless a country has a small economy that is connected to other, larger economies with big firms – like

Israel or Taiwan – we argue that the ideal is a mix between managerial firms and new firms. Such a combination creates a constant, creative, and productive tension. Many small firms innovate, while big firms commercialize, refine, and mass produce goods and services based on new ideas.

Capitalism in the Aftermath of the Financial Crisis

The financial crisis that began in 2008 provides several key lessons concerning the role of incentives in the four types of capitalism. When incentives are wrong, entrepreneurs can be worse than unproductive; they can be destructive. The ongoing recession is a result of such destructive entrepreneurship in the financial arena, exacerbated by enormous amounts of leverage in financial firms. The crisis started in the sub-prime mortgage sector and spread to the rest of the economy. While entrepreneurship is needed to sustain growth, we must also be careful to properly align incentives in the system to protect against destructive entrepreneurship that can wipe out an entire economy.

The point that entrepreneurs drive an economy is still relevant, and may be more so than ever before. The current crisis has taught us about the limitations of big firms. With bailouts for big firms, the government was propping up old businesses like General Motors or Chrysler, and in the process diverting scarce capital that could have been used for financing new businesses. This strategy is not a recipe for long-term growth. It may be the answer to prevent the economy from running over a cliff, but over the long-run, a vibrant, growing economy must maximize opportunity for new firms at the margin. China, for one, has started its enormous transition by withdrawing from the state-run sector and putting its marginal resources in the entrepreneurial sector. India has done much of the same. The importance of the entrepreneurial sector is clear: if we look at economic history, there is serious cause for hope.

The Kauffman Foundation’s recent research has found that half of today’s *Fortune* 500 companies were formed during a bear market or recession.

That is an amazing statistic. Half of the *Inc.* 500 companies (a list of the fastest growing companies) were formed during recessions or slowdowns. Tough economic times do not need to defer renewal and regeneration in an economy hit by a downturn.

More to the point, all net new jobs created from 1980 to 2005 in the United States were created in firms less than five years old. Without the continual influx of entrepreneurial firms, employment in the United States would have shrunk. To put that another way, something like 30 percent of today's U.S. gross domestic product is produced by firms that did not exist before 1980. That is a truly remarkable number. If America is going to restore the economic leadership it once had, it will have to rely on a rebirth and another wave of entrepreneurial activity. Entrepreneurial job creation has not received enough attention in Washington yet, but it is a subject that will be crucial to the welfare of the United States and to the rest of the world in the years ahead.

Robert Litan is the Vice President for Research and Policy at the Kauffman Foundation and a Senior Fellow in Economic Studies at the Brookings Institution. During his career, Dr. Litan has authored or co-authored 22 books, edited another 15, and authored or co-authored over 200 articles in journals, magazines, and newspapers. Since the onset of the financial crisis, he has authored or co-authored a number of essays on financial reforms for the Brookings website (www.brookings.edu). Dr. Litan has served in several capacities in the federal government: as Associate Director of the Office of Management and Budget, Deputy Assistant Attorney General, Antitrust Division, Department of Justice; and Staff Economist, Council of Economic Advisers. He received his bachelor's degree in Economics (summa cum laude) from the Wharton School of Finance at the University of Pennsylvania, his juris doctorate from

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