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SAVING CAPITALISM FROM THE CAPITALISTS:

Unleashing the power of financial markets to create wealth and spread opportunity

Opening

There is widespread belief that free markets (and especially free financial markets) do not benefit the common man, let alone the poor: they are only an instrument for the rich to get richer. In this book not only do we show this belief is false, but in fact the opposite is true. Free markets (and especially free financial markets) are the single most important tools to eliminate poverty and spread opportunity.

An example from the introduction should make our point clear: Sufiya Begum, a poor Bangladeshi villager needs twenty-two cents to buy the raw material for the stools she makes. For lack of better alternatives, she has to borrow this money from a middleman, who forces her to sell the stools back to him as repayment for the loan. Of course, he sets the price. Thus, Sufiya gets only two cents for a hard day's labor.

In this vignette many see the worst of capitalism: exploitation of labor. But this is not an inevitable consequence of capitalism. In fact, this situation could not be further away from the essence of capitalism: free access and competitive markets. It is the lack of access to competitive financial market or a friendly financial institution where Sufiya Begum could borrow at reasonable rates, which keeps her labor captive. But why don't these markets and institutions emerge?

Many have tried to answer this question by pointing to culture, history, and religious traditions. Our answer is much simpler, these markets and institutions do not emerge because the capitalists (in this case the middleman) oppose them, and for a very obvious reason. They stand to lose if access to finance became freer and they faced competition. The problem is that people do not distinguish enough between true free market capitalism, which implies competition and equal access, and the failed version Sufiya Begum sees and both get tarred with the same brush. Economists as a profession have also been guilty in focusing on the idealistic virtues of the former while the public all too often only sees the likelihood of the latter. This book is an attempt to bridge the gap.

An Example

The starting point in this book is that competitive free markets do not flourish in a state of anarchy, in a state of "laissez faire, laisse passer". This belief does incalculable harm to the cause of markets. Instead, they flourish in a delicate middle ground, where there are enough rules and regulations to facilitate access and competition and not so many that the market is suffocated.

Take an example: If you wanted to fly and there was no supervisory authority in the airline industry and no regulations enforcing safety standards, you would be very reluctant to fly fledgling airlines. You would prefer the established ones that had the track record and the reputation. So a complete lack of safety regulations in the airline industry would favor established firms, making entry impossible, and killing competition.

But if the regulation said that you had to have a proven 5 year track record of profitable flying before you would be allowed to take passengers, new entry would again be killed off, for how can new entrants have a proven record? It is the delicate middle ground, where enough rules are in place so that people feel confidant in flying the new entrants, but not so much that the new entrants can never qualify, where competition flourishes.

But once you accept that some rules and regulations are needed but not too much, the old mantras are useless. One cannot adopt the posture of the traditional right saying any government suffocates markets. Neither should one adopt the posture of the traditional left that markets are terrible and governments should replace them. The right position is the Goldilocks position – neither too little nor too much of the government is best for markets.

Quoting from the book:

"While the absence of rules make the playing field uneven, too many rules of the wrong kind make it uneven again—a truly free and competitive market occupies a very delicate middle ground between the absence of rules and the presence of suffocating rules. It is because this middle ground is so narrow that capitalism in it best form is very unstable. It easily degenerates into a system of the incumbents, for the incumbents, by the incumbents."

But to understand how this can be achieved, you have to ask "Who typically makes the laws and rules, and what is their objective?"

Who makes the rules?

Let us take the most common political system, a democracy. In a democracy, it is assumed the rules are made by the people through their elected representatives for the common welfare. A long tradition at the University of Chicago, called private interest theory, says this is simply not true. Consider an example:

Recently, President Bush levied tariffs on imported steel. The alleged reason was to protect American jobs. But there are only 190,000 workers producing steel and 9 million in steel-consuming jobs. While steel prices in the United States have indeed gone up, steel prices have fallen below US levels in the rest of the world as exporters redirect their steel away from the United States. This hurts US industries that rely on steel as an input: they can no longer compete with foreign manufacturers who now enjoy cheaper steel inputs. As a result, some US manufacturers have threatened to move their manufacturing abroad. Far more American jobs were put at risk outside the steel industry by the steel tariffs than were saved in it. So the tariffs were certainly not in the public interest.

The truth is that the tariffs were a subsidy, not so much to the steel workers who could have been helped at lower cost to the economy through a direct handout, but to the owners and top managers of the distressed steel firms, who benefit handsomely from the tariff. The reason they prevailed is that the concentrated lobbying power of established powerful private interests often outweighs the public interest – as a test, how many of us really know the details or cared enough to voice opposition to the tariffs.

It is because rules are made (or not made) in the interests of incumbents, the middleman who exploits Sufiya or the old uncompetitive steel firms in the US that the Chicago school has opposed regulation. Unfortunately, too many, including some from Chicago, have concluded that the solution is to press for extremely limited government. Confronted with the plight of people like Sufiya Begum, the only answer traditional free marketers could offer was "laissez faire, laissez passer". As a result, anybody with a sense of compassion would naturally move to the Left, which at least appeared to be offering solutions. All the political attempts to improve capitalism focused on limiting markets rather than on enhancing them. We do not want to tame the creative power of markets, we want to liberate it. But to liberate this powerful force, we need to strengthen the political support in favor of capitalism.

So what do we propose?

In sum, markets need political support to provide the right amount of rules and regulations that will allow them to flourish. What will ensure that political action is public spirited and that the rules and regulations are not made to protect the interests of a few incumbents? What will ensure that incumbents have largely the same interests as everyone else?

We propose four pillars. Like pillars bearing a load, these proposals are mutually reinforcing and will help achieve the objective. But taken by themselves, they may seem perverse.

1) Efficient ownership

Inefficient owners tend to oppose rules that promote competition – they see the downside of freer markets rather than the upside of opportunity that those markets bring. Moving more from income taxes which penalize the efficient to property taxes, which demand you earn on the wealth under your custody would be a step in the right direction in reducing inefficient ownership. Of course, we do not advocate increasing taxes – God Forbid -- simply shifting their form.

Studies show that firm owners who inherit their control tend to be particularly inefficient. All too often, managerial genes are not passed on by the founder. So an inheritance tax levied on transfer of active control of corporate assets (though not on passive ownership) would be another step in the right direction. In this respect, estate taxes, while not targeted in the best way possible, perform a useful role. We do not support the recent move to eliminate them.

2) Open borders

Borders open to trade and capital flows tend to do something very good for rule making. Domestic firms are forced to compete with foreign firms, essentially creating a proxy competition between domestic rule makers and foreign rule makers. Domestic incumbent interests can no longer prevail since inefficient rules favoring certain segments will jeopardize the entire economy. Open borders provide a country's people the best chance that their country's rules will be made so as to enhance the public interest. The enormous growth in the last 30 years, and the progressive removal of overweening protective regulation in country after country is testimony to this.

So we believe that anti-globalization protesters are barking up the wrong tree. By closing down borders, they will make sure that opportunity will be killed, especially for the young, and that large domestic firms will prevail.

3) Safety Net:

Competition creates winners and losers. This is indeed one of the biggest sources of tension between democracy and markets. People who are left behind by the economy still have their political power. The problem, however, is that those without hope in the market economy will understandably use their political power to subvert its foundations: witness the march of steelworkers on Washington to demand protection. Worse, incumbents will ride the coattail of this anti-market protest and pressure for protection as well. This might lead, as in the steel example, to protectionism, which typically tends to be long lasting. In fact, we have only recently recovered from the closing down of markets that took place in the 1930s.

Thus, a safety net is needed to give people who are left behind hope, so that they do not turn against markets and become easy political prey for the incumbents.

But much of the safety net in developed countries is focused on protecting firms, not people. In developing countries, there is still too much reliance on the family as the safety net. The safety net should be formal and should protect people not firms.
It should not be merely in the form of handouts. Instead, it can be designed to make the market work better, for example by providing job training and healthcare that will make people see opportunity in the market again.

Here, we see the administration's proposals to create more individual savings schemes as steps in the right direction – this will help separate individual security from the security of the firms they work for.

Finally, all this is not to say we do not have an ounce of compassion. Only that compassion is a tricky foundation to base policy on.

4) Awareness:

But the most important force in democracy to ensure rules are set well is awareness of you, the people. It is your belief in the power of free markets, and your knowledge of what could go wrong, which will keep incumbents and politicians in check. And it is to reinforce that awareness that we have written this book.