

“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 its best form is very unstable. It easily degenerates into a system of the incumbents, for the incumbents, by the incumbents.”

--Raghuram Rajan & Luigi Zingales,

*A Conversation with Raghuram Rajan and Luigi Zingales,
authors of*

***SAVING CAPITALISM FROM THE CAPITALISTS:
Unleashing the power of financial markets to
create wealth and spread opportunity***

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What is the problem with capitalism?

There is widespread belief that the most important tools of capitalism, free markets, do not benefit the common man, let alone the poor. We argue in this book that this belief is misplaced. The last three decades have shown that free markets are perhaps the most important tools for lifting the huddled masses out of poverty. But why then does the belief exist? We argue that it is because markets need rules to flourish. Rules are set by the politically powerful. Even in democracies, these do not always represent the common man. Instead, they often serve special interests such as dominant industrialists and well-connected bankers. The common belief is that these people want markets to be free. The truth, however, as we document in this book, is that in many countries the dominant business elites have created rules that prevent markets from becoming truly free, thus keeping their peoples mired in poverty. The reason is that even while providing opportunity to the many, free markets undermine the position of the existing powers by creating competition for them. In order to protect their positions then, capitalists can turn against free markets, the single most important tool of capitalism. How do we keep markets free? How do we save capitalism from the capitalists? That is the subject of this book.

Can you give examples of your point?

We can offer many examples from other countries. But let us try the harder task of providing some examples from the United States, a country that has been in the vanguard of free market capitalism.

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. 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 thirty thousand workers who were bussed to Washington to press for tariff protection were nothing but human shields used to protect incumbent firms' interests, at the expense of the vitality of the free market system.

Consider another example. It is usually difficult to borrow without collateral, that is, wealth that a lender can seize. Often, the only asset that poor families in the United States have is equity in their house. The rich, however, have assets other than the house they live in, such as bank accounts, stocks and bonds, other real estate, etc. Now, a number of states have passed laws allowing a person filing for bankruptcy to keep their house from being seized by creditors (this is called a "homestead exemption"). Ostensibly, this is to keep a roof over the heads of the poor. In reality however, such a law hurts the poor. The law prevents their home from serving as collateral because creditors can no longer seize it. Since they have no other collateral, they cannot borrow to buy the house in the first place. By contrast, the law benefits the rich. Not only do they have enough collateral and reputation outside their home to be able to borrow, they can also salt away enough value in palatial homes so that they can enjoy a decent life style even if their businesses fail. Careful academic studies have shown that access to finance for the poor has fallen, while the rich have been able to borrow more, in states with a high homestead exemption. This is yet another example of the free market being curbed through rules devised by the elite.

Are you then simply reiterating the traditional "Chicago School" that many have associated with Milton Friedman and others: an unfettered approach to free markets?

Not quite. First, the Chicago school is often misunderstood. Anarchy is not the most fertile environment for free markets. So all but the most libertarian elements of the Chicago school have always advocated a role for the government in enforcing basic property rights and contracts. But one also has to ask what will make that government set the right rules? The novelty in our approach is to ask how the government can be made to set rules in the interests of the people when it is so often captured by private interests. Our proposals in the book recognize that politics and economics cannot be kept separate in modern democracies (there is a reason why the field was once called political economy), and that some forms of intervention may be necessary in the greater interest of keeping the market free.

Where does the position you outline in Saving Capitalism from the Capitalists fall in the greater dialogue on globalization?

We believe in open borders. By forcing different political regimes to compete on common economic turf, open borders are one of the most important forces preventing governments from pandering to their domestic elites and ignoring the larger public. If Malaysian manufacturers have to compete with Thai manufacturers in selling to common markets, they cannot afford archaic, anti-competitive regulations in the Malaysian financial system for that will make Malaysian production costs higher and put them at a competitive disadvantage.

The evidence is out there for everyone to see – there has been immense rise in wealth and opportunity over the last thirty years in both developed and developing countries as borders have opened up. But we also see that open borders can hurt some economically, and quite apart from humanitarian concerns, there is also the danger that those who are hurt can assert themselves politically to close borders. This is why we think it is important to keep hope alive for those who are hurt by the forces of free markets. By emphasizing both free, open borders and a helping

hand, we think our position is in between the unbridled libertarian and those who want to keep out all things foreign.

Don't free markets create inequality?

Human beings are born with an unequal distribution of talents. By focusing resources on those with talents, free markets could accentuate inequality. But the poor are also talented. So it is not inevitable that free markets will increase inequality. In fact, if you take the world as a whole, free markets have reduced inequality in the last 30 years by helping countries like China and India grow out of dire poverty.

But the United States has a highly unequal income and wealth distribution, at least relative to Europe and Japan.

Yes, indeed. The United States is highly unequal. But accompanying that inequality is mobility. The people in the poorest ten percent of the population, aside from a small permanent underclass, do not remain the same all the time. They are students or the temporarily unemployed, who get jobs or open businesses and escape their poverty. In other words, free markets give people the opportunity that allows them to tolerate greater inequality: because they know they have a fair shot at reaching the top.

Don't you worry then about recent scandals in the corporate sector?

Yes indeed, we worry. The main problem is not so much the wrongdoing itself. The problem is that they create the perception that the system is unfair, that there is one rule for the rich and one for everyone else. This makes the existing inequality much less palatable. And when that perception is accompanied by a general economic downturn, these perceptions could well turn to anger against the system. Sometimes such anger will result in just the right amount of reform. But if unchecked, and if egged on by the right interests, such anger could result in a movement against free markets. We have seen this happen before, during the Great Depression, and it took nearly half a century for capitalism to recover. Everyone loses as a result.

The focus of most economists is on efficiency, not distribution. You focus on both. Why is that?

Economists typically do focus on policies that will create the biggest pie possible (what are known as efficient policies). They don't bother that much about how the pie is divided (distribution). In part, this is because they argue that once you create the biggest pie possible, there is always some way to divide it to make everyone better off. In practice, however, better distribution does not always follow from greater efficiency. Because markets depend on the political establishment for rules and regulations, a perception that the pie is divided unfairly will put pressure on the political establishment to change the rules and suppress the market. So while greater efficiency may permit better distribution, perceived unfair distribution can make it impossible to achieve greater efficiency.

What is the link between democracy and markets?

Markets and democracy are intimately related. On the one hand, truly free markets can only arise in a democratic regime. Markets need an institutional framework to develop and prosper. The ruling elite has a natural tendency towards biasing this framework in their favor. This unfortunately occurs even in democratic regimes, but it is most pronounced in un-democratic ones. Thus, free markets have more of a chance in democracy.

On the other hand, well-functioning markets create the competition that curbs privilege and spreads wealth. This undoubtedly helps democracy set root.

Many people tout creative destruction as one of the main drivers of capitalism. What about the people creative destruction leaves behind, i.e. those without jobs and skills?

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. We do have to care for them, and not just for humanitarian reasons. As the Nobel prize-winning economist, Amartya Sen, has pointed out, famines do not occur in democratic countries because democratic governments do move resources to affected areas. The problem, however, is that those without hope in the market economy will understandably use their political power to subvert it: 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. Thus, a safety net is needed to give these people hope.

Your mentioning the need for a safety net reminds me of the traditional welfare state. Is this the Chicago way to the welfare state?

The welfare state is the wrong answer to the right question. Following the Great Depression Western Democracies realized their market economies could not survive in the absence of a safety net. This reasoning is still valid today. Unfortunately, they thought that the way to protect individuals was to restrict competition and protect the existing corporations. This was not simply a mistake. The lobbying power of incumbents pushed them in that direction. It took fifty years to undo many of these inefficient restrictions. We claim protection can be offered to the individual without interfering with the functioning of the market. In fact, 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. Our mantra is “protect people, not firms”.

Your book analyzes the precondition for the development of free markets. Do you have any suggestions on how the world can help the emergence of democratic market economies in countries like Iraq and Saudi Arabia?

There is a view that all that is needed in these countries is to replace the current leadership, hold elections, and democracy and free markets will follow. The template is the one the United States followed in Japan after World War II.

Our analysis, however, suggests at least one big important difference. The single biggest source of economic value in Iraq and Saudi Arabia is oil, unlike in Japan, which has never enjoyed an abundance of natural resources. The problem with a natural resource like oil is that it can give governments who control it immense power without their having to seek the support of the people. Concentration of economic power leads, almost inevitably, to concentration of political power. We can see this today in Venezuela where the government recognizes that to break the popular opposition strike, it has to regain control of the oil. By contrast, if economic power were more widely spread, the government would need the consent of the people to function, and this would force it to become more democratic. In other words, we are not so sanguine that a change of regime will be sufficient to make the oil rich countries into healthy democracies. Far more has to be done to spread economic power.

So would you advocate simply redistributing resources to set a country on its way towards becoming a free market democracy?

Redistribution, if properly managed, works sometimes. For example, we believe land reform in Continental Europe in the 19th century, and in Japan and Korea after World War II were significant factors in their becoming market democracies. But people who get the resources have to know how to use them well else they will quickly lose those resources and not serve as a countervailing force to the government. All too often, redistribution simply changes the identity of the elites, or even leads to a greater concentration of economic wealth, as we have seen happen with the voucher privatizations in Eastern Europe. There is, we believe, no easy route.

So what is the hard way you propose?

Some of our proposals are not controversial. For example, we advocate a good education system and sound healthcare to enable the average citizen to take advantage of economic opportunities, as well as a well-developed financial system to give them the resources to create their own wealth. Others are more controversial. For instance, open borders that force domestic elites to make rules in the interests of their public and a taxation system that prevents undue concentration of economic power in the wrong hands. While we think each proposal may not work by itself, taken together they provide the checks and balances that make them work.

Why did you decide to write this book?

Any economist who has been in contact with underdevelopment sees the most important question in economics to be “What keeps countries underdeveloped and what can we do to change this?” We came at this question after studying financial markets. It is particularly obvious that well-developed and free financial markets help countries grow. Why then do so many countries have underdeveloped financial markets? The immediate answer was that they do not have the necessary infrastructure: the rules, regulations, and systems to support properly functioning financial markets. But this is not a complete answer for the question then is why they do not have the infrastructure: Why was India capable of producing software for the world’s stock exchanges but incapable of using that software in its own exchanges to enhance transparency and good governance (matters have changed somewhat since then)?

That is when the answer we propose in this book started forming: that in far too many countries, the domestic elites simply do not want free markets and keep the infrastructure underdeveloped to achieve this goal. We then realized the answer pertained not just to financial markets but also more generally to all kinds of markets. What crystallized our desire to write the book were the growing protests against free global markets. We felt that the protesters, even those motivated by reasons other than naked self-interest, had the arguments backwards. Instead of enhancing the power of large corporations and domestic elites, free markets actually curb their power and channel their activities into more productive ones. We thought it important to get this message out. Hence this book.

You both received your doctorates from MIT, the homeground of the “liberal Cambridge School.” You both now teach at Chicago. How has being immersed in these two different schools of thought influenced your work?

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Clearly, having been at both places, we recognize the strengths and possible weaknesses of each approach. There is a lot more common ground between these schools than comes out in public sound bites. Nevertheless, there are real differences that lie behind the caricatures. The Cambridge school believes in the power of the government. But the natural question is what keeps the government working in the interests of the public. As we document in the book, the answer is competition between governments. The Chicago school believes in the power of competitive markets. But what allows markets to develop and keep functioning? We think the answer has to include an important role for governments. So we believe our book is a synthesis of the lines of thought of the different schools, and our background has indeed prepared us to attempt it.

Rajan was recently awarded the Fisher Black Prize by the American Finance Association for having made the most significant contributions to the field of finance by someone under the age of 40. How much of this is for the ideas that are described in the book?

We have been working together for over ten years now. The book brings together our thinking as well as the thinking of our academic colleagues. It is based on sound research (which was recognized by the prize committee), but we have also made the research more accessible by linking together the arguments into a coherent worldview. In joining the dots provided by the research, we have gone beyond it. So there is much in the book that is new, but it is based on a solid foundation of certified research.