

Good capitalism, bad capitalism

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IN THE first two decades of the 21st century, capitalism has become the dominant economic system in the world and, yet, increasingly contentious. In one or another form, private enterprise, property and markets are the central institutions of economic life worldwide except in a few countries such as North Korea. However, rising inequality, unending wars, terrorism, an inadequate response to accelerating global warming, a disastrous financial crash that destroyed the jobs and savings of millions and a slow recovery that excluded millions have led to widespread populist backlashes against this system. These backlashes have sometimes mutated into support for authoritarian politicians and economic nationalism. As if these challenges were not enough, a pandemic came out of nowhere in 2020 to cause widespread disease and death and knocked the global economy backward.

So, is capitalism good or bad? A good economist will reply: 'It depends.' It depends on how governments manage capitalists, regulate markets, provide essential public goods and services that markets cannot supply, and without which markets cannot function properly. When managed well, history makes it clear that capitalism is the most productive and creative economic system, one that has lifted the vast majority of the world population out of poverty in the last two centuries, more than one billion people in the previous 30 years alone. A free economy not only leads to prosperity, but it also supports flourishing democracies and human rights, as seen most brightly in Western Europe. On the other hand, if not done well, capitalism leads to deeply unequal societies and political capture by the economically powerful who use the state to advance their benefits excluding and suppressing the rest of the population. At its worst, capitalism leads to dictatorships, fascism, and unparalleled destruction.

Good capitalism: benefits of mixed economies

IT IS useful to get some definitions clear. What is capitalism? First, the capitalist system is where private individuals, their privately or jointly owned companies, and corporations own capital and produce goods and services. Capital includes both physical — land, buildings, machinery, technology — and financial capital, ie, financial assets that can command physical capital. Second, it is an economic system run mainly by markets where buyers and sellers meet voluntarily to exchange products, goods and services. Buyers and sellers freely carry out these activities without interference by the state.

There is no such thing as pure capitalism. Instead, what we have are mixed economies, where governments take an active role. In Europe and North America's advanced economies, governments can tax as much as 35 to 45 per cent of what the economy produces every year and spend even more through its borrowing from the private sector. They run more than a third of all economic activities, including providing vital public goods and services such as law and order, education, health, infrastructure, defence, etc. Second, critically, only governments have the authority to issue fiat money. Third, governments have the power to regulate private sector activity and use it extensively.

It is this mixed economy capitalism that has delivered unprecedented economic and social progress in the world in the last 200 years. To keep the discussion concise, let us focus on three related indicators of progress: people's health, which is the most summary indicator of their welfare; second, their incomes; and third, their escape from poverty.

Take first the case of health. Perhaps the best summary measure of social health is population size: in the initial stages of development, when people become healthy and prosperous, populations grow. According to the US Census Bureau's summary of research, the world population hung by a thread for most of human history: anywhere from one million, at most a few million. Even after food supply became more reliable when agriculture came about 12,000 years ago, the global population was at best 10 million and increased very slowly. It took all that time since then to reach the one billion people at the beginning of the 19th century, when science, the Industrial Revolution, and capitalism began to reign. In the next 200 years, the world population has increased by more than seven times to reach 7.8 billion people. A related indicator is that, for most human history, average human life

expectancy has hovered around 30 to 35 years until the beginning of the 20th century. Average life expectancy has since then more than doubled to 72 years in 2020.

Regarding income, Germany's University of Groningen provides the best estimates of historical income levels by updating the late British economist Angus Maddison's work. About 2000 years ago, the average per capita income in the world was generally uniform across civilisations at about \$800-900 in today's prices and there it remained for 1000 years. Albeit imperial capitals and commercial centres such as Rome, Baghdad, Damascus, Istanbul, Delhi, Xian and Beijing were much more prosperous. However, prosperity was concentrated in the elite and transient because a broadly based vibrant private sector could not emerge under absolute rule.

Incomes started rising in a sustained way only after the advent in Western Europe of mercantilism, the first age of capitalism, in the 17th-century. With its independent companies and joint-stock corporations, the birth of the scientific age, and the rapid growth of world trade, per capita income in Western Europe and America jumped to about \$1300. The rest of the world stagnated. At the beginning of the 19th century, when the first Industrial Revolution arrived, capitalism harnessed entrepreneurs, technology, and trade together in an explosive growth of productivity and rising incomes. Western and North American income crossed \$2,500. Latin Americans also joined the growth race soon. For most of the next 200 years, income and living standards mainly grew in North America, Western Europe, and Japan increasing to more than \$40,000. East Asia joined that global capitalist trade from the 1960s, while the rest of Asia and African joined later. On average, world per capita income has increased by more than ten times since the Industrial Revolution.

The spectacular rise in incomes also enabled the great escape from poverty. Using the definition of extreme poverty threshold of a daily consumption level of international \$1.90, global poverty has declined from 80 per cent of the world's population at the start of the 19th century to less than 10 per cent in 2019. The decline in poverty has been particularly spectacular in the last 30 years, when massive economies such as China and India, and middle-size ones in Asia such as Bangladesh and Vietnam, joined global markets. About 1.2 billion people have escaped poverty in these Asian countries in the last 30 years, thanks to international trade and integration.

Why mixed economies work: Adam Smith

WHAT enabled mixed economy capitalism to achieve these results? Interestingly, the fundamental insights still come from Scottish moral and political economy philosopher and University of Glasgow Professor Adam Smith. His history-altering work, *An Inquiry into the Wealth of Nations*, was published in 1776, the same year as the declaration of American independence. While Smith was fully aware of altruism's moral benefits, he suggested that economic welfare was best achieved when human beings pursued their own interests. In his famous words, 'It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest.' Second, he pointed out that productivity increased manifold when there was a division of labour. It is common sense to understand that everyone cannot produce everything. But Smith went beyond that; citing the example of a pin-maker, he suggested that specialisation in tasks of even such a small manufacturer increased productivity. The division of labour led to the third insight: the need for trade, competition, and markets to exchange goods and services that workers and firms provide. Fourth, there was his unifying insight of the 'invisible hand' of competitive markets that would coordinate economic activities. Much of modern economics' task has been to extend and drill down rigorously into the ideas of Smith, rightly regarded as the founder of economics.

Although Adam Smith was a champion of markets, he was more cautious about capitalists. In the *Wealth of Nations*, Smith warned that, given an entirely free hand, merchants would be driven by 'mean rapacity', use 'interested sophistry', and build 'oppressive monopolies.' He was concerned about inequality: 'whenever there is great property, there is great inequality.' Further, Smith, the advocate of the division of labour, was deeply concerned that such division of labour and repetitive work in a factory may lead to 'the torpor of his mind' and 'be at the expense of intellectual, social, and martial virtues' of workers. He was aware of the plight to which the labouring poor would 'necessarily fall, unless government takes pains to prevent it.' And how to prevent it? By providing compulsory State-supported education, especially for poor children.

Smith's appreciation of the state's critical role was not merely academic. As the former

commissioner of customs for Scotland, he helped raise Britain's revenues. It is worth mentioning that Great Britain was the leader in tax collection through most of modern economic history. Two hundred years ago, the British government collected 11 percent of national income as taxes, more revenue than what Bangladesh collects today.

The fundamental insights of Adam Smith have tested well in history. Capitalism works when institutions adequately govern it by providing justice, law and order, good public education and health, infrastructure, and regulations to support well-functioning free markets. Finally, care has to be taken to prevent market capture by oligarchs. It is worth noting that the United States, the heartland of capitalism, does precisely that — it even breaks up large corporations every few decades, such as IBM, AT&T, and Microsoft in the last 50 years.

Corrections to capitalism and market failures

WHAT did Adam Smith miss? He missed how capitalism would need well-functioning cities. Capitalism had led to rapid urban growth; the share of the world's population living in cities has increased from 8 percent in 1800 to 53 percent today. Writing his opus in the age of mercantilism, at the dawn of the first industrial revolution, Smith did not foresee the explosive productive power of the first, second, and third industrial revolutions in the next two centuries. These technologies would give birth to the large and massive-scale factory production that would create cities not just as marketplaces but also as production centres. Modern economics goes further. It recognises the importance of cities as more than the location of production: it sees cities as unleashing the productive power of agglomeration. By bringing people together, cities create not only efficiencies of large-scale production attracted to large markets but also knowledge, exchange of ideas, and cultural riches.

However, cities are not naturally created by markets. Developing and managing thriving cities requires high-quality urban planning, infrastructure and public services, and coordination. They need good local governance to carry out these activities. Because these elements in most emerging market economies are missing, urban development and good capitalism fail to be achieved. Nearly a third of the world's urban population live in slums, often lacking essential public services such as drinking water, schools, health care.

Further, these cities often fail to provide the essential ingredient, jobs. That is, not enough investment takes place in the cities to create good jobs. Much of the migration into these cities happens because of ‘push’ factors, out of distress, instead of ‘pull’ factors that draw workers into cities because jobs offer higher wages. As a result, in recent decades, urban growth in South Asia and Africa have been accompanied by high urban poverty. Unless governments can provide effective local governance and leadership to develop cities properly, capitalism will not deliver its benefits.

Modern economics, understandably, also has a much deeper understanding of what it calls ‘market failures’ that lead to ‘bad capitalism.’ In these cases, the government needs to step in to correct these failures.

First among these failures is when markets fail to balance supply and demand, especially at the national level. When demand for goods and services falls below supply, national income falls, the economy goes into recession. Demand can decline due to various factors: exports and remittance earnings fall; interest rates increase drive investment down; the falling value of assets make consumers feel poorer; and, most broadly, because consumers and investors lose confidence and cut back on spending. All this sets into motion a downward spiral of incomes and employment: producers cut down production, decrease their demand for raw materials and intermediate goods, and lay off workers. Because income falls, there is then another round of decline in demand. The most extreme example was the great depression of the 1930s that swept through the United States and Europe, sometimes leaving one in four workers jobless. Even before the great depression, recession and the cycle of booms and busts were frequent occurrences causing unemployment and suffering. British economist John M Keynes’s seminal contribution was to point out that the government’s task during a recession is to raise expenditures to stimulate demand and the economy. However, it needs stressing that this problem of falling demand and excess capacity is mainly a problem of higher-income economies with excess capacity. For lower-income economies, the challenge is to raise the ability to supply goods and services.

Another critical failure is that markets fail to account for how it affects third parties and society. Thus, leather manufacturers can profit by making their customers happy; but if they do not treat their waste and contaminate the water supply, the community suffers. Broadly, this explains capitalism’s grand failure to curb pollution and damage to the environment.

Another example, from the positive side, is that education and good health benefit not only individuals but also society at large. Because markets, per se, cannot value this, the private sector can never provide education and health care to the extent society needs, and the government must step in to provide these public goods.

Modern economics also appreciates the profound importance of information and knowledge and how access to them determine market outcomes. On one side, this is precisely the reason decentralised markets work so well. Because the market processes an inconceivable amount of information every hour it works, governments can never successfully replace markets. However, when access to information is unequal, sellers know more than buyers or vice versa, then one of the parties can become victims of fraud. Further, human psychological weaknesses can make people victims of private-sector greed: viz through the sale of tobacco, liquor, and drugs. Economically struggling people can be too harried to have the mental ability to make the right decisions. Public policies are needed to make corrections in these cases.

Finally, unregulated capitalism and markets do not guard against extreme inequality. A certain amount of inequality is necessary: if markets did not reward hard work, education, savings, investment, and risk-taking by investors, there would not have been the economic progress the world has seen. However, if wealth and capital are too unequally distributed, to begin with, markets can quickly increase inequality. As that has harmful consequences for social stability and economic performance, governments use tax, spending, and welfare policies to reduce inequality.

Good capitalism and democracy

MODERN economics also has a better understanding of political economy and rent-seeking. Capitalists will try to use state power to their advantage — and extract excess, ‘monopoly’ profits and rents, when possible. Because industrialists’ power was unchecked during the early industrial revolution in England, working people – from young children to the aged — worked in dreadful conditions in factories and mines. It fell upon the German Friedrich Engels, then managing his family’s factory there, to write about this in the ‘The Condition of the

Working Class in England' and draw Karl Marx's attention. The rest is history.

To paraphrase Adam Smith, it was not to the benevolence of the capitalists we owe the progressive, shared benefits of capitalism that we best see in Western Europe. Instead, we owe it to the political and social uprising and revolutions that swept across Europe and the USA in the past two centuries. We also owe it to the rise of the powerful working class, trade union movements that persisted through the 20th century and sometimes exercised political power through revolutions or the ballot box. Only these countervailing powers of working-class and trade union movements and state intervention on their behalf enabled the gains of capitalism to be shared widely. Fascinatingly, this historical perspective is also found in the writings of American Nobel laureate Simon Kuznets, the father of the much criticised but indispensable national income accounting methods.

This history leads us to the profound linkage between good capitalism and democracy. Capitalism works best when governed by political competition and democratic rights of the people. The people's needs are best met when they have a voice in choosing accountable governments and policies at both the national and local levels. Such a system can ensure over the long run that the benefits of capitalist prosperity are widely shared. And in a virtuous cycle, when the benefits of capitalism are shared, democracy is also most robust and sustainable.

On the other side, there is a vicious cycle that connects bad capitalism and authoritarian rule. When the capitalists have too much power, the benefits of capitalism are not widely shared. The only way for such inequality to sustain itself is through authoritarian rule. But there is a fundamental conflict here: authoritarian and dictatorial rule, by its very nature, weakens justice, erodes the rule of law, and creates conflict and uncertainty. Private enterprise cannot thrive under such conditions. Capital and people flee, economies and societies stagnate. That is the story of large parts of the developing world.

That is why while many countries can become middle-income countries, very few countries — only 15 in the last 60 years — manage to become a high-income country. The rest falls into the middle-income trap. Because these countries could not build the institutions of competitive markets and accountable governments, they stagnated and sometimes even regressed. In 1900, Argentina had about the same per capita income as France, Germany,

and a tad less than the United States. The other countries became global economic powers. Argentina, which failed to escape the grip of its capitalist oligarchs and landed elites, fell far behind.

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